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"AWAKENING THE SLEEPING GIANT:" INDIA AND FOREIGN DIRECT INVESTMENT IN THE 21ST CENTURY

Mark B. Baker*

I. THE SLEEPING GIANT

"India is the greatest democracy in the world. The government here is like an old elephant: vast, but slow and avoidable. Clever people can keep from being stepped on."[1]

Imagine, a great leviathan nation-state, larger in size and population than its neighbors and a member of a class of two,[2] one of whom is historically and politically outside the main stream of the capitalist world. We are speaking of course about India, land of many cultures and languages and an anomaly of the highest order.

Like a modern day Rip Van Winkle, India is in its own way awakening from a long and somewhat unfulfilling time of its existence.[3] Unlike the "old man of the mountain," however, it is not the dying echo of bowling pins being struck that awakens India, but rather the "sounds of money" being made as a result of the freewheeling world of foreign trade and investment in the twenty-first century.[4] The siren song of development is ringing all about the less developed world, and to miss its call is to allow nations and its citizens to languish in perpetual poverty.

This paper attempts to introduce the reader to the reality of India's past and future and the role of law in bringing the giant closer to its potential.

II. INDIA'S POTENTIAL IN ATTRACTING FOREIGN DIRECT INVESTMENT

India has the potential to become one of the most dominant economies in the world, yet its economic progress since gaining its independence in 1947 has generally been masked by its perception as an impoverished country, as has its

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* Associate Professor of International Business Law, McCombs School, University of Texas at Austin; B.B.A., University of Miami, 1968; J.D., Southern Methodist University, 1974.
The author gratefully acknowledges the efforts of Ms. Carolyn DeClue, B.B.A., University of Texas at Austin, 2000; J.D. Candidate, 2005, University of Texas at Austin.

1. Mark Jenkins, *The Ghost Road*, OUTSIDE, October 2003, *at* http://outside.away.com/outside/features/200310/200310_burma_1.html (last visited Mar. 22, 2005).

2. The other, of course, is the People's Republic of China.

3. *See generally* WASHINGTON IRVING, RIP VAN WINKLE (1907), *available at* http://www.classicallibrary.org/irving/rip/ (last visited Feb. 14, 2005).

4. *Id.*

vast potential for further development.[5] It has the fourth largest economy in the world and the second largest Gross Domestic Product (GDP) among developing countries based on purchasing power and a large and growing market.[6] India has the second largest population in the world, behind only China, with over a billion people.[7] While only occupying about 2.4% of the world's land mass, the country supports almost 16% of the global population.[8] India's consumer market has been rapidly growing, and now stands at approximately 300 million people with increasing purchasing power.[9] This market is growing at an estimated 8% per annum, and the demand for several consumer products is growing at over 12% per annum.[10] With its strategic location, India has access to the large South Asian market, and is a favorable location for a multinational company to expand throughout Asia.[11] These benefits have been further complimented by the government's progressive liberalization of foreign direct

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5. Le-Nhung McLeland & Herbert O'Toole, *Patent Systems in Less Developed Countries: The Case of India and the Andean Pact Countries*, 2 J.L. & TECH. 229, 232 (1987).

6. MINISTRY OF EXTERNAL AFFAIRS (INDIA), INV. & TRADE PROMOTION DIV., BRIEF FOR PROMOTION OF FOREIGN INVESTMENT & BUSINESS, *at* http://www.embindia.org/Articulos/Investbrief0804.htm (Aug. 4, 2004) (last visited Mar. 22, 2005).

7. As of 0:00 GMT, March 1, 2001, India had a total of 1,027,015,247 people. It is the second country, following only China, to cross the one billion population mark. OFFICE OF THE REGISTER GEN., CENSUS OF INDIA 2001, PROVISIONAL POPULATION TOTALS: INDIA (2001), http://www.censusindia.net/results/resultsmain.html. *See generally* Xizhe Peng, *Population Policy and Program in China: Challenge and Prospective*, 35 TEX. INT'L L.J. 51, 54 (2000). In an effort to improve the quality of life of the Chinese people and to create the groundwork for social and economic development, China has adopted a population policy designed to reduce its population to a sustainable level. *Id.* China's government feels that government intervention is essential in slowing the population growth rate and maintaining the optimal population size.

> The basic principles of the current population policy in China include the promotion of late marriages and deferred child birth, the urging of people to have fewer health births, the promotion of the practice of one birth per couple, and the encouragement of a longer birth spacing for families who may have practical difficulties if they were only to have one child.

Id. India, on the other hand, uses different approaches to deal with its population growth. First, they legalized abortion up to twenty weeks of pregnancy under the Medical Termination of Pregnancy Act of 1972 (MTP). Andrea Krugman, *Being Female Can be Fatal: An Examination of India's Ban on Pre-Natal Gender Testing*, 6 CARDOZO J. INT'L & COMP. L. 215, 216-217 (1998). They also try to reduce the population growth rate by educating women and promoting family planning with television and billboard ads. Additionally, the government has tried to convince couples to abort female children. *Id.* Since there is pressure to have only one or two children, many Indian women go through prenatal gender testing so that the family can ensure their one or two children will be male. Due to negative social consequences, such as discrimination resulting from prenatal screening, this test was banned in 1994 with the Pre-Natal Diagnostic Techniques (Regulation and Prevention of Misuse) Act. *Id.*

8. *Population of India: Studies and Research on India's Population*, INDIAN CHILD, *at* http://www.indianchild.com/population_of_india.htm (n.d.) (last visited Mar. 22, 2005).

9. Indian Inv. Ctr., India's Investment Climate: Why Invest in India, *at* http://iic.nic.in/iic2_a.htm (2000) (last visited Mar. 22, 2005) [hereinafter Indian Inv. Ctr.].

10. *Id.*

11. *Id.*

investment (FDI) policy.[12] One may contend that at present, India has recognized that FDI is an important driver for economic growth and has gone to great lengths to clarify and simplify its investment procedures. However, despite its vast potential, India has failed to achieve a reputation, nor reach its potential, as an attractive destination for FDI. This article attempts to bring a semblance of order and understanding to the inherently complex and somewhat contradictory use of law to enhance FDI.[13]

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12. Lakshmi Chand, *Foreward* to SECRETARIAT FOR INDUS. ASSISTANCE, INDIAN MINISTRY OF COMMERCE AND INDUS., MANUAL ON FOREIGN DIRECT INVESTMENT IN INDIA – POLICY AND PROCEDURES 3 (2004), http://64.233.167.104/search?q=cache:JQBwuXsRMXcJ:www.embkoreain.org/sub7/FDIManual_Mar2k4_Eng.pdf+%22MANUAL+ON+FOREIGN+DIRECT+INVESTMENT+IN+INDIA%22+%22POLICY+%26+PROCEDURES%22+&hl=en.

13. Like so many of the other issues shrouded in controversy, the matter at hand is not one of first impression. Indeed, in an article favored by this author, Ewell E. Murphy, Esq., has crafted a marvelous "fairy tale" that is replicated herein. A reading of the piece clearly illustrates the constant pressures that the less-developed world faces when opening its borders to FDI.

> Once upon a time, in a country far away, there lived a King. His only wish was the contentment of his people—the Plumed-Serpent People, they were called, in echo of a legend of their race. Each dusk the King would pace the garden of his castle-hill above the volcano-guarded lake, considering how he might defend his people from the Giant. For in the North from sea to sea marched with the King's domain the vaster-yet dominion of a Giant. Already had the Giant seized [for more].
>
> Pondering this shadow on his subjects' happiness, the King one evening summoned to his garden Lord Porfirio, tall, fearless warrior from the South, and asked him how they should attack the Giant.
>
> 'The best attack,' Porfirio advised, 'is no attack at all. Admit the Giant People to our land. We've many skills to gain [from] them, and gold. As they wax docile, so shall we grow strong. We will rise up one day, and cast them out.'
> And so the Giant People came. Their skills, indeed, they taught, but haughtily, and without gaiety or grace. The gold they brought seemed nothing to the wealth they wrung from their adopted soil. At last Plumed-Serpent Land rose up and cast them out, and Lord Porfirio as well.
>
> That does not end the tale. In time the Giant Folk returned, not to seize land, but worse, to dominate in devious ways the crafts and harvests of the realm. Once more the people murmured and the King paced sadly in the garden of his castle-hill. At length he called Lord Louis, clever baron of the West, and bade him solve the problem of the Giant.
>
> 'We must construct a Wall,' the Baron said, 'too tall for Giant Folk to scale, with gates so low and narrow that their knights must leave both horse and lance behind and enter, if at all, as harmless peddler-men.'
>
> And in a twinkling it was done: a mighty bulwark rose across Plumed-Serpent Land . . . and for a time the Plumed-Serpent People dwelled content.
>
> But not for long. Too soon Plumed-Serpent Land grew restive and the people murmured once again. One night a deputation of his liegemen gained an audience in the garden of the King: not mighty warriors of the South or clever barons of the West, but city knights and merchant guildsmen from the King's

III. INDUSTRIAL POLICY OF 1991

Notwithstanding that stated above, India has made many great improvements over the last decade in achieving economic growth and poverty reduction.[14] The most significant advancement came in 1991 when India removed governmental obstacles and allowed its doors to open to foreign investment.[15] The Industrial Policy of 1991 greatly enhanced the business climate in India and provided clarity to foreign businesses looking to invest in India. Prior to the implementation of this policy, foreign investment was allowed on a case-by-case basis. It was usually capped at 40% of the total equity capitalization, unless the investment included sophisticated technology that was unavailable in India, or the venture was predominately export-oriented.[16] The new welcoming attitude of the government was reflected in the Industrial Policy, which liberalized the internal licensing requirements for businesses and retained only minimum procedural formalities.[17] In the words of policy makers: "The industrial policy reforms have reduced the industrial licensing requirements, removed restrictions on investment and expansion, and facilitated easy access to foreign technology and foreign direct investment."[18]

> own North, where the Plumed-Serpent People grow as strong as, and stronger than, the Giant's men. Lord Heron was their chief.
>
> 'Great King,' he said, 'we do not contradict the wisdom of the Wall. We cavil solely at the gates. They open only inward, and thus hinder our own exits with our goods. As for their height and beam, they block the taller lancemen of the Giant, admitting only puny squires. Our blades grow rusty and our sinews soft, for want of fight. How shall we master jousting in the world beyond the Wall, lacking fit sport at home?'
>
> The King turned wordlessly away. They say he wanders wordless yet—when the night is clear and a full moon enchants the castle-hill, he can be seen pacing his garden, pondering the inconstancy of men and the perversity of walls.

Ewell E. Murphy, Jr., *The Echeverrian Wall: Two Perspectives on Foreign Investment and Licensing in Mexico*, 17 TEX. INT'L L.J. 135, 135-36 (1982).

14. Nicholas Stern, World Bank Group, Public Finance and Policy for Development: Challenges for India, Silver Jubilee Lecture (Jan. 10, 2002), http://econ.worldbank.org/files/11413_Nick_Stern_NIPFP_revised_Feb_28-02.pdf (last visited Mar. 22, 2005).

15. Nicky Jatana, *Did Whirlpool Make its Mark in India?: N.R. Dongre v. Whirlpool Corp.*, 10 TRANSNAT'L LAW. 331, 336 (1997). The new government attitude towards FDI is reflected in the 1991 New Industrial Policy Statement, which specifically states that "[t]he government will therefore welcome foreign investment which is in the interest of the country's industrial development." MINISTRY OF INDUS., GOV'T. OF INDIA, STATEMENT ON INDUSTRIAL POLICY (1991), http://siadipp.nic.in/publicat/nip0791.htm (last visited Mar. 31, 2005); *see also* PRICE WATERHOUSE, DOING BUSINESS IN INDIA 23 (1996). This was an attitude that many countries adopted as FDI was seen as more of a building block for developing countries, rather than a stumbling block that resulted in dependency on larger, developed countries. *Id.* India, however, was a latecomer in the adoption of this belief. *Id.*

16. PRICE WATERHOUSE, *supra* note 15 at 24.

17. TONY KHINDRIA, FOREIGN DIRECT INVESTMENT IN INDIA 18 (1997).

18. SECRETARIAT FOR INDUS. ASSISTANCE, INDIAN MINISTRY OF COMMERCE AND INDUS., MANUAL ON FOREIGN DIRECT INVESTMENT IN INDIA—POLICY & PROCEDURES 9 (2004), *available at* http://64.233.167.104/search?q=cache:JQBwuXsRMXcJ:www.embkoreain.org/sub7/FDI

Under this policy, most investments can come in under the automatic route.[19] There are also categories of investment that, while not listed as eligible for automatic approval, may be eligible as such if the investment falls within the foreign investment caps.[20]

Prior to 1998, however, nonresidents had to obtain prior approval pursuant to the terms of the Foreign Exchange Regulatory Act (FERA), even for investments eligible for automatic approval.[21] This policy was further liberalized on January 20, 1998, when the Reserve Bank of India (RBI) changed the foregoing rule by allowing Indian companies to issue and export equity shares to foreign investors without prior approval.[22] The automatic route now requires only that investors file the required documents, a declaration on Form FC, with the concerned Regional Office of the RBI within thirty days after the issue of the shares to foreign investors.[23] The RBI gave this permission to Indian companies in an attempt to simplify FDI procedures under

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Manual_Mar2k4_Eng.pdf+%22MANUAL+ON+FOREIGN+DIRECT+INVESTMENT+IN+INDIA%22+%22POLICY+%26+PROCEDURES%22+&hl=en (last visited Mar. 31, 2005) [hereinafter INDUSTRIAL POLICY].

19. All investments for FDI/Non Resident Indian (NRI)/Overseas Corporate Bodies (OCB) up to 100% fall under the automatic route except:

> (i) All proposals that require an Industrial License which includes:
>
> (a) the item requiring an Industrial License under the Industries (Development & Regulation) Act, 1951;
>
> (b) foreign investment being more than 24 per cent in the equity capital of units manufacturing items reserved for the small scale industries; and
>
> (c) all items which require an Industrial License in terms of the locational policy notified by Government under the New Industrial Policy of 1991.
>
> (ii) All proposals in which the foreign collaborator has a previous/existing venture/tie up in India . . . the modalities prescribed in Press Note No. 18 dated 14.12.1998 of 1998 Series, shall apply to such cases. . . . However, this shall not apply to investment made by multilateral financial institutions such as ADB, IFC, CDC, DEG, etc. as also investment made in IT sector.
>
> (iii) All proposals relating to acquisition of shares in an existing Indian company in favor of a foreign/NRI/OCB investor.
>
> (iv) All proposals falling outside notified sectorial policy/caps or under sectors in which FDI is not permitted.

Id. at 13, ¶ 3.3.

20. For example, investment in the development of petroleum products and pipelines up to 51% can go through the automatic approval process. Other examples include the development of small and medium sized oil up to 60%, gas fields up to 51%, and export enterprises with equity ownership between 51% and 100%. Therefore, it is necessary to check with the RBI before one prepares an investment proposal to determine which sectors are currently eligible for automatic approval. TERRENCE F. MACLAREN, ECKSTROM'S LICENSING IN FOREIGN AND DOMESTIC OPERATIONS: JOINT VENTURES § 14.75 (2003).

21. *Id.*

22. *Id.*

23. INDUSTRIAL POLICY, *supra* note 18, at 15, ¶ 3.12; *see* KHINDRIA, *supra* note 17, at 19-20. If a license is not required, the company only needs to file a memorandum with the Ministry of Industry. This memorandum is just an information sheet to keep the Ministry aware of developments in different industries. It is not an application for approval. *Id.*

this "automatic route."[24] The prior licensing procedures represented many hurdles for foreign companies looking to do business in India.[25] The Industrial Policy of 1991 was expected to avoid the red tape and corruption in the bureaucracy, and liberate Indian business.[26] Now that the many restrictions have been lifted, companies with nonresident interests are placed on equal footing with Indian wholly-owned companies.

Other results of the 1991 policy included increasing income and improving the living standards of Indian residents over the last decade. The reform program has been the driving force behind accelerating economic growth, further declining poverty, and strengthening India's external position.[27]

IV. LABOR

Another great benefit for businesses looking to invest in India, in addition to the liberal governmental policy, is the local employment population. Labor is the most dominant input for production in virtually every type of business.[28] India is well positioned with regard to local market size and labor costs as it has one of "the largest domestic markets in the world and it has a large labor force available at relatively low cost."[29] These workers are also very well-educated, especially in the areas of engineering and science.[30] "India's vast reservoir of knowledge resource - engineers, scientists, technicians, managers and skilled personnel, are among the best in the world."[31] These resources continue to grow as the country welcomes approximately 200,000 new engineers per year.[32] The labor population also continues to expand, as a number of the software developers and technology professionals are beginning to return to India from other countries to which they had emigrated for better career opportunities. In fact, in the last two years, about 35,000 software workers have returned to India.[33] As a result, in certain sectors, such as the production of computer

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24. INDUSTRIAL POLICY, *supra* note 18, at 15, ¶ 3.12.

25. KHINDRIA, *supra* note 17, at 19.

26. *Id.*

27. Michael Carter, Opening Remarks, Workshop on Improving India's Investment Climate, *available at* http://lnweb18.worldbank.org/SAR/sa.nsf/Attachments/mor/$File/Mor.pdf (July 30, 2003) (last visited Mar. 22, 2005).

28. KHINDRIA, *supra* note 17, at 217.

29. DEV. ECON. GROUP, WORLD BANK GROUP, IMPROVING THE INVESTMENT CLIMATE IN INDIA 10 (2002), http://www.ifc.org/ifcext/economics.nsf/AttachmentsByTitle/ICindia_proof_3.pdf/$FILE/IC-india_proof_3.pdf (last visited Mar. 22, 2005) [herinafter IMPROVING INVESTMENT CLIMATE].

30. *Id.* at 10-11.

31. SINHA, *supra* note 6.

32. Bruce Einhorn, *For India, a Shrinking IT Monster; Suddenly, Indians are realizing that their big edge in English skills and multinational investment should hold off China's software threat*, BUSINESSWEEK ONLINE, July 1, 2003, *at* http://www.businessweek.com/technology/ content/july2003/tc2003071_2518_tc058.htm (last visited Mar. 22, 2003).

33. *See generally* Khozem Merchant, *Economic Revival Could Lead to 'A Reverse Brain Drain': NON-RESIDENT INDIANS: Expatriate Bankers and Technologists are being Lured*

software, India offers investors a potentially higher rate of return than any other nation.[34] In the language of one author, "India offers what in a competitive world may be the most valuable software of all: minds that have been permitted to be open, inquisitive and creative, and men and women who are fluent in the global language of business, English."[35] In fact, India placed second in a poll of 400 executives who were asked to rank the labor forces of developing nations, ranking it ahead of China.[36] Indeed, historically the Indian labor force

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Back to India, FINANCIAL TIMES, Dec. 9, 2003. In the past, India's labor skills have been a detriment to the country, as many Indians have left to find work in more promising business climates. For example, Wall Street is filled with Indian financiers, and there are even more Indians who work in technology in the Silicon Valley. While India still has a large population of talented workers, this trend has resulted in a brain drain of over twenty million Non-Resident Indians (NRIs), depriving the country of many of its most promising workers and increasing the ratio of poor, uneducated workers. *See id.* As India's business climate begins to revive, this trend could reverse, providing India not only with the return of her skillful and educated NRIs, but also with the benefit of their experience of working in developed countries. These NRIs are a special group, as they are credible professionals, rather than the typical blue-collar immigrants India has experienced. These prodigal Indians could impart their knowledge to new businesses in the country, which in turn would increase the overall business climate exponentially. Not only would Indian businesses begin to flourish, but the increased business experience in the companies would influence foreign investors to increase contributions into the country. *See id.* Many experts feel that this could be the bridge needed between India's ideas and opportunities for investment and the business and political decision makers in the west. In fact, Rajit Gupta, an NRI and senior partner of the business consultancy, McKinsey, and former United States President Bill Clinton are involved with an investment fund that reflects this trend. Many business experts identify the NRIs as a tool used to influence western investors, as their success provides support for arguing the benefits of investing in India. Throughout the period that these NRIs have prospered in other countries, they have transferred little of this wealth back home. One of the reasons for low foreign investment numbers is that the NRIs did not support their home country in the past. *See id.* China, on the other hand, receives much of its foreign investment from expatriate Chinese. The return of the NRIs to India may be the payoff that Indian leaders have been unsuccessfully encouraging their natives to send back home. Indian leaders are starting to recognize the benefit of NRIs returning home, and in an effort to promote more, they have proposed the ability for Indians to have dual nationality if they live in one of seven countries, including the United States and the United Kingdom. Today, Indian technology companies have been heavily recruiting NRIs, as many of them have lost their jobs in the United States due to the bursting of the dot-com bubble. NRIs began assessing the Indian job market, and have reached the realization that coming back home to their families does not mean compromising their career as it used to. In fact, as many companies have begun outsourcing labor to India, NRIs have the opportunity to switch the country in which they work without having to change companies. Other NRIs have returned, not because they lost their jobs in America, but because they now see opportunities to do challenging work in India, rather than having to wait until opportunities arise in the United States. Despite the fact that many are still skeptical of corruption and regulatory burdens present throughout the bureaucracy of India, others see long term growth potential and opportunity, as India's technology and other skilled industries have started to gain prominence in the international arena. *See id.*

34. Ilyana Kuziemko & Geoffrey Rapp, *India's Wayward Children: Do Affirmative Action Laws Designed to Compensate India's Historically Disadvantaged Castes Explain Low Foreign Direct Investment by the Indian Diaspora?*, 10 MINN. J. GLOBAL TRADE 323, 337 (2001).

35. Birman Maharjan, *India-China: The Elephant Versus the Tiger, in* INVESTMENT GAME, (Inter Press Service, 1997), *cited in* Kuziemko, *supra* note 34, at 335.

36. Kuziemko, *supra* note 34, at 335.

has a generally favorable attitude toward foreign investment.[37] This is generally because of a perception of a greater degree of professionalism in foreign business, and because of a lingering expectation of higher wages.[38] The foreign company may, however, continue to employ foreign nationals, as "[t]he government of India has not introduced any legislation to provide for the Indianization of employment."[39]

Many multinational companies have taken advantage of the "personnel pool" which India possesses. The recent trend prevalent in business today, which was initiated by large companies such as Intel and Microsoft, is that of business-process outsourcing abroad. "[H]ardly a week goes by without another multinational announcing that it's opening or expanding an office in India so that low-salaried, high-skilled Indians can provide all sorts of back-office support."[40] Much of this support is in the form of call centers where Indians provide technical support and answer customer questions from half a world away. This is one area where India is confident that they can continually overpower China, largely because the Chinese do not speak English as well as the Indians.[41] While China offers many other benefits for this type of outsourcing, the language barrier has deterred many companies from expanding there.[42] Companies also have chosen India over other potential Asian outsourcing destinations due to its size. For example, countries such as the Philippines have a large population of talented workers but are nowhere near the size of India, where the talent pool is considered inexhaustible.[43]

The aforementioned trend has only just started, and is expected to gain momentum as more and more businesses recognize the economic benefits of outsourcing this type of labor.[44] Even businesses that are reluctant to follow this trend will shortly be forced to do so in order to remain competitive with those already realizing great savings.[45] Many investment professionals have

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37. PRICE WATERHOUSE, *supra* note 15, at 25.

38. Until recently, companies managed by foreign enterprises have paid higher than their local competitors and this perception remains prevalent in India. *Id.*

39. *Id.* at 104

40. Einhorn, *supra* note 32.

41. *Id.*

42. *Id.* For example, Adobe Systems considered opening a base in China, but decided against it as they saw language barriers. Adobe, however, has been consistently expanding its Indian operations due to the great quantity of English-speaking talent there. In fact, in late 2002 the company moved into a new $10 million building in Noida, just outside of Dehi, which is the only building the company actually owns. In addition to the English speaking population, Adobe also chose India because of the availability of intelligent and talented manpower. *Id.*

43. *Id.*

44. "With the trend gaining momentum, more that 40% of U.S. companies will develop software or test it, offer tech support, or provide storage functions overseas by 2004, according to market consultancy Gartner." Olga Kharif, *The Hidden Costs of IT Outsourcing*, BUSINESS WEEK ONLINE, Oct. 27, 2003, *at* http://www.businessweek.com/technology/content/oct2003/tc20031027_9655_tc119.htm (last visited Mar. 22, 2005).

45. As with the outsourcing of electronics manufacturing in the early 1990s, even companies who are outsourcing business-processes support are reluctant to disclose such a fact

noted that India has become a constant theme in discussions between investors and executives, as executives are trying to show that they are at the forefront of this trend, rather than lagging behind and sacrificing crucial cost savings. Rajiv Chauhri, a portfolio manager of the Digital Century Technology hedge fund, stated that "[e]veryone is facing the same problem – revenue growth has slowed, and they have to reduce costs. So increasingly, they're being asked to articulate their plans to move some development and back office to India."[46]

While the financial savings associated with outsourcing call centers are considerable, some companies feel that there are too many headaches involved in dealing with India. Despite the fact that there is a large population of highly skilled workers, many Indian workers do little more than what is specifically assigned. Many companies have experienced delays due to Indian workers not understanding what they were expected to do or not completing contingencies associated with the project. Managers think that many of the problems are a result of Indian workers not being onsite, and feel that these delays are more costly and outweigh the benefits of lower wages.[47] In addition to delays, there

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in an effort to avoid political unpopularity. *See* Pete Engardio, *Corporate America's Silent Partner: India*, BUSINESSWEEK ONLINE, Dec. 15, 2003, *at* http://www.businessweek.com/bwdaily/dnflash/dec2003/nf20031215_8942_db046.htm (last visited Mar. 22, 2005).

> In the current political climate, politicians, pundits, and angry laid-off workers are hunting for scapegoats for America's largely jobless recovery. You can't find better targets than China and India, both of whom undeniably are gaining from the sweeping restructuring of American technology, financial services, and telecom companies. Companies from AT&T Wireless (AWE), to Bank of America (BAC) are issuing pink slips at home while staffing up in Delhi, Bombay, and Hyderabad.

Id. However, as more and more firms recognize the financial benefit of such outsourcing, companies will be forced not only to follow the trend, but also to disclose their outsourcing to avoid falling stock prices. Again analogous to off-shore electronics manufacturing, companies who outsource will have higher stock prices and healthier returns on capitals. Companies such as Motorola and Lucent who were slow to sell off their domestic factories and outsource this sector were less competitive and heavily criticized. *Id.*

46. *Id.*

47. Many entrepreneurs are starting to feel that the benefits of outsourcing these jobs to India are overstated. For example, one startup in Austin, Texas, called the K3 group, employed only American labor because they felt there were too many costs associated with India that outweighed the savings. The business was started by Ryan Kinzy who had experienced these problems while working in a larger high-tech company that did outsource labor. He stated:

> There were too many headaches in dealing with India. We often got spaghetti code that was functional, but couldn't grow . . . . The time difference was very difficult. The explanation, "They program while you sleep" doesn't hold water. Too often, a problem would arise and they would respond the next day with, "Well, we weren't sure what you wanted to do" – and a whole day was lost, time and again. Before long we were four months behind schedule. It was also very difficult to remotely manage a project unless you had a very strong infrastructure over there of U.S.-style managers. Finally, the rising costs over there make it tougher to justify.

David E. Gumpert, *A New Tide in Offshore Outsourcing*, BUSINESSWEEK ONLINE, Jan. 12, 2004, *at* http://www.businessweek.com/smallbiz/content/jan2004/sb20040112_0920.htm (last visited Mar. 22, 2005). Other companies have decided it is worth paying a little higher wages to avoid the remote, offsite employees. For example, a small company out of Boston, Massachusetts,

are other hidden costs associated with outsourcing jobs to India. For example, one company that outsourced its software development to India had to spend more money to have the bugs and glitches repaired once it was returned than if they had just developed it in the United States.[48] There are also costs related to setting up and managing operations abroad, such as paying domestic engineers to work late into the night so that they can communicate with the Indian teams, and possibly changing internal processes to accommodate offshore partners.[49] Finally, even the cost of wages is starting to increase in India as more companies follow the trend of outsourcing there. As a result, many companies may be actively looking to places cheaper than India, such as Argentina or Colombia.[50]

V. TAX TREATMENT

India has also made changes to its tax law designed to increase foreign investment. However, before these tax advantages can be properly understood,

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called cMarket decided to do just that. *See* David E. Gumpert, *U.S. Programmers at Overseas Salaries*, BUSINESSWEEK ONLINE, Dec. 2, 2003, *at* http://www.businessweek.com/smallbiz/content/dec2003/sb2003122_8887.htm (last visited Mar. 22, 2005). In looking for programmers, cMarket found that experienced American programmers would cost about $80,000 per year, with benefits adding an additional $5,000 to $10,000. *Id.* On the other hand, they could hire Indian programmers for about $40,000. *Id.* Jon Carson, the entrepreneur who started cMarket, liked the idea of saving that much money but did not want to push jobs away from this country. Also, he did not want to risk having all of the essential work being done by people he did not know and could not communicate with face-to-face. As an alternative, he decided to offer the jobs to Americans at a large discount to the going rate for experienced programmers: $45,000. *Id.* Due to the down economy, he received many resumes from qualified, experienced programmers who were having trouble finding work. He feels that this resulted in giving him control over quality and timing that he would not have had if he had outsourced to India. One concern, however, is that offering Indian-style wages to American workers may cause a decline in the American standard of living, even though it would help solve the country's problems with creating jobs. *Id.*

48. In 2002, Empowered Software Solutions (ESS) earned approximately $500,000 in revenues earned solely from fixing buggy software that was outsourced to India. *See* Kharif, *supra* note 44. ESS spent five months fixing the software intended for a web portal that contained missing code and pages that were not connected. *Id.* ESS said that they could have done the work originally for about $900,000 here in the United States. Instead it was outsourced to India, and the Indian developer not only returned the application with many errors, but did so at $1 million over budget. *Id.* When companies look at the total cost, rather than just wages, they will probably see that the cost is comparable to getting the work done domestically. However, many companies are unaware of all of the costs involved because they cannot accurately measure their productivity, efficiency and costs prior to and after outsourcing. One other hidden cost includes the potential loss of clients. While outsourcing companies claim that there is no harm to service quality or loss of customers, many are worried that their problem will not be accurately resolved because there is no on-site personnel to help customers. Many purchasers are transferring their business to companies with on-site technical support in order to ensure that their questions will be answered. There is also concern that businesses are sacrificing quality for cost, as software developed offshore is estimated to have about thirty-five to forty percent more bugs than software produced domestically. *Id.*

49. *Id.*

50. *Id.*

one must first comprehend which entities constitute a company under Indian law. Businesses are governed by the Companies Act of 1956 (Companies Act) which extends to the whole of India.[51] A company under this Act is a legal entity, separate from its members, directors and managerial personnel. A company has perpetual succession, limited liability, and its own rights and obligations, resulting in the existence of a corporate veil.[52] With regard to income tax, the definition of "person" in the Income Tax Act of 1961 includes a company.[53] Indian income tax is also expressed in terms of residency. A company is considered an Indian resident if it is an Indian company or if the control and management of its affairs are situated wholly in India during a given year.[54] Therefore, if a company is incorporated in India, it qualifies as an Indian resident and would be subject to the Income Tax Act. As such, the company would be liable to India for its worldwide income, which is obviously something the company would want to avoid.[55]

If a company is not considered a resident under Indian law, its income is either defined by a tax treaty between the company's home country and India or by § 5(2) of the Income Tax Act.[56] There has been much uncertainty over the

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51. KHINDRIA, *supra* note 17, at 90.

52. *Id.* at 90-91.

53. Under Chapter 2 of the Income Tax Act, "income tax shall be charged . . . in respect of the total income of the previous year or previous years, as the case may be, of every person." C.I.S. Part I (1961), INCOME TAX ACT ch. 2, § 5(2) of the Ministry of Finance of the Government of India, New Delhi, Apr. 1, 1962, *available at* http://incometaxindia.gov.in/Income%20tax%20act.asp (last visited Mar. 22, 2005) [hereinafter Income Tax Act]. This income is based on the sale of a company's products and provisions of its related services. KHINDRIA, *supra* note 17, at 161-62.

54. *Id. See* INCOME TAX ACT, ch. 2, § 5(1).

55. Section 5(1) states the extent of a resident's tax liability as follows:

> Subject to the provisions of this Income Tax Act, the total income in any previous year of a person who is a resident includes all income from whatever source derived which:
>
> a. is received or is deemed to be received in India in such year by or on behalf of such person;
>
> b. accrues or arises or is deemed to accrue or arise to him in India during such year; or
>
> c. accrues or arises to him outside India during such year.

Id. See also KHINDRIA, *supra* note 17, at 161.

56. Section 5(2) defines a non-resident's income as follows:

> (2) Subject to the provisions of this Income Tax Act, the total income in any previous year of a person who is a non-resident includes all income from whatever source derived which
>
> a. is received or is deemed to be received in India in such year by or on behalf of such person
>
> b. accrues or arises or is deemed to accrue or arise to him in India during such year.

Income Tax Act, ch. 2, § 5(2)

> *Explanation 1*: Income accruing or arising outside India shall not be deemed to be received in India within the meaning of this section by reason only of the fact that it is taken into account in a balance sheet prepared in India.

foreign company's tax liability to India.[57] As a result, India has tried to simplify the assessment of taxation by introducing a system of advance tax rulings.[58] In order to actuate the benefits of the rulings, a foreign company must determine which parts of its income are subject to tax in India.[59] This income includes that which is derived outside of the country if it is received or deemed to be received in India.[60] The nonresident company's income would also include income that accrues or is deemed to accrue in India.[61] Thus, if a foreign company delivers goods to its joint venture in India, the income has been accrued in India and is subject to the Indian income tax even though no payment has been exchanged.[62] The tax paid to India does not necessarily relieve the foreign company from any tax liability on its income owed to the company's home country.[63] In order to minimize the burden of double taxation, many countries have entered into bilateral agreements to decide the amount of taxes each country will receive in international business transactions.[64] India is authorized to enter into treaties with foreign countries, and the treaty would prevail over any inconsistent provision of the Income Tax Act.[65] Where a tax treaty does exist, the corporate tax applicable to the foreign company can be the lower rate prevailing in either of the two countries.[66] Consequently, it is essential for a foreign company to determine if its home country has signed such an agreement with India before commencing business there.

As part of India's continued rehabilitation of its tax code, on May 27, 1995, the President granted his assent to a Union Budget, presented by the Indian Finance Minister, which contains provisions beneficial to trade and industry.[67] For example, the tax-exempt amount per year was increased from rupees 35,000 to 40,000.[68] Also, the top 40% tax rate now applies to income

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> *Explanation 2*: For the removal of doubts, it is hereby declared that income that has been included in the total income of a person on the basis that it has accrued or arisen or is deemed to have accrued or arisen to him shall not again be so included on the basis that it is received or deemed to be received by him in India.

Id. See also KHINDRA, *supra* note 17, at 173.

57. KHINDRA, *supra* note 17at 174.

58. *Id.*

59. *Id.*

60. Most foreign companies make efforts to receive their income outside of India, this includes making sure that the income is not actually received by a bank in India that was opened by either the company or its agents. *Id.*

61. *Id.*

62. A foreign company can, however, arrange to pass the title of the goods to its joint venture company outside of India, the right to receive the payment has accrued outside of India, and as such, is not subject to Indian income tax. *Id.*

63. *Id.* at 180.

64. *Id.*

65. *Id.*

66. Indian Inv. Ctr., *supra* note 9.

67. P. R. V. Raghavan, *Tax and Forex Changes in India Aim to Increase Foreign Investment*, 7 J. INT'L. TAX'N. 17, 17 (1996).

68. *Id.*

levels starting at rupees 120,000 instead of the prior level of rupees 100,000.[69] Payments and capital gains made by various Indian businesses have also been exempted from tax.[70] The rate for import duties for capital goods has been greatly reduced, and there are no countervailing duties charged for certain industries.[71] Another beneficial change in the tax structure of India is the extension of the system of modified value added tax, or MODVAT, to additional industries.[72] The justification for MODVAT was to limit the effects of multiple duties on excisable commodities used as imports in the manufacture of other excisable commodities.[73] "The extension of the MODVAT system to a large category of industries . . . is expected to make capital-intensive industries and the export industry in India more competitive in the international market."[74]

VI. SPECIAL ECONOMIC ZONES

In addition to taxation, India is using other incentives to encourage foreign investment in free trade zones, export-oriented undertakings, and industrial disinclined areas.[75] To encourage investment in the setting up of an industrial park or special economic zone, the government has provided for 100% income tax exemption for ten years within a block of fifteen years during a period ending March 31, 2006.[76] All investments in export-oriented units and free trade zones are given automatic approval subject to sectoral norms.[77] With

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69. *Id.* X-Rates, *Historic Look Up*, *at* http://www.x-rates.com/cgi-bin/hlookup.cgi (n.d.) (last visited Mar. 2, 2005). The current conversion rate (as of October 30, 2003) is rupees 45.33 per USD 1.

70. For example, payments made by an Indian company engaged in the business of aircrafts, which acquires an aircraft or aircraft engine on lease for a foreign government or foreign enterprise under an agreement approved by the central government, is exempt from tax in India. Also, venture capital companies and funds are exempt from tax on income derived from dividends and long term capital gains from investment in equity shares in a venture capital undertaking. An Indian company in the business of developing, maintaining, and operating an infrastructure facility is also eligible for tax benefits, such as profits exempt from tax for the first five years, and thirty percent of its profits exempt for the following five years. Raghavan, *supra* note 67, at 17-18.

71. *Id.* at 18.

72. *Id.* MODVAT is similar to the Value-Added Tax system used in European countries. It provides for an instant credit of excise duties paid on imports used in the manufacture of other excisable goods.

73. KHINDRIA, *supra* note 17, at 157.

74. Raghavan, *supra* note 67, at 18.

75. P. R.V. Raghavan, *India's Recent Reforms Open the Way for Investment and Technology*, 6 J. INT'L. TAX'N. 162, 162, 166 (1995).

76. INDUSTRIAL POLICY, *supra* note 18, at 23 ¶ 6.3.

77. The Manual on Foreign Direct Investment in India states:

> The Development Commissioners (DCs) of [Export Processing Zones (EPZs)/Free Trade Zones (FTZs)] Special Economic Zones (SEZs) accord automatic approval to projects where:
>
> (a) Activity proposed does not attract compulsory licensing or falls in the

the exception of a few activities, up to 100% of FDI is permitted through the automatic route in special economic zones.[78] India has also introduced incentives applicable to proposals for Electronic Hardware Technology Parks (EHTP) and Software Technology Parks (STP) to stimulate the electronics industry.[79] All proposals for investment in these units are eligible for automatic approval if they meet the parameters required for the automatic route.[80]

The Indian government has established one Free Trade Zone and seven Export Processing Zones in order to achieve their "goals of promoting self-reliance, developing industries, acquiring technology and technical know-how, attracting foreign participation with secured returns on their investments and providing an export market . . . ."[81] In these zones there are opportunities for imports and promotion of exports for both Indian and foreign citizens.[82] Units within these zones are offered many incentives, such as exemption from customs duties and simplified clearance procedures on imported raw, tooling

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services sector except IT enabled services;

(b) Location is in conformity with the prescribed parameters;

(c) Units undertake to achieve exports and value addition norms as prescribed in the Export and Import Policy in force;

(d) Units undertake to achieve positive net foreign exchange earnings; and

(e) Unit is amenable to bonding by customs authorities.

Id. at 21 ¶ 5.1.

78. Activities would require government approval for foreign direct investment, include the following:

1) arms and ammunition, explosives and allied items of defense equipments defense aircraft and warships;

2) atomic substances;

3) narcotics and psychotropic substances and hazardous chemicals;

4) distillation and brewing of alcoholic drinks; and

5) cigarettes/cigars and manufactures tobacco substitutes.

See id. at 39 Annexure I - II.

79. These schemes "offer a package of incentives and facilities like duty free imports on the lines of the EOU Scheme, deemed export benefits and tax holidays." *Id.* at 24 ¶ 7.1.

80. The Manual on Foreign Direct Investment in India states:

The Directors of STPs in respect of STP proposals; and the Designated Officers in respect of EHTP proposals accord automatic approval if:

(a) items do not attract compulsory licensing;

(b) location is in conformity with the prescribed parameters;

(c) unit is amenable to bonding by the Customs, and all the manufacturing operations are carried out in the same premises and the proposal does not envisage sending out of the bonded area any raw material or intermediate products for any other manufacturing or processing activity.

All proposals for FDI/NRI investments in EHTP/STP units are eligible for approval through automatic route subject to parameters listed in para 3.3.

Id. at 24 ¶ 7.2.

81. *See generally* KHINDRIA, *supra* note 17, at 40. The one Free Trade Zone is located at Kandla (Gujarat), and is known as "KAFTZ". One of the seven Export Processing Zones is located in Santa Cruz, Maharashtra, and is used exclusively by the government to promote the setting up of units that manufacture electronic products. The remaining six are multiple-product zones and are located in Noida, Uttar Pradesh; Cochin, Kerala; Falta, West Bengal; Chennai, Tamil Nadu; Visakhapatnam, Andhra Pradesh; and Surat, Ahmedabad. *Id.*

82. *Id.*

and packaging materials. Imports on capital goods are duty-free, and the zones are placed under Open General License, giving them a total waiver of licensing for imports of capital goods and production materials (but a unit within one of the zones cannot import items banned for import in other parts of India). One hundred percent non-resident equity participation is permitted in any form of organization, and non-resident enterprises are not required to associate with resident Indians in investment or participation. Finally, a foreign investor may freely repatriate his investment of capital and capital appreciation, profits invested back into the project, and dividends, after deduction of applicable taxes.[83]

In addition to units produced in the zones above, a unit can set up in any other location if it proposes to export the bulk of its manufactured goods and services under the 100% Export-Oriented Unit (EOU) scheme.[84] Under this scheme, industrial units that export their entire production for ten years, or five years for products liable to rapid technological change, are eligible for the same incentives as units in the zones, in addition to other incentives granted only to EOUs.[85] These units are distinguished from other similar schemes in that they can be established anywhere in India, subject to locaional criteria, environmental laws, and land-use and zoning laws.[86] Units must achieve a minimum local value added content of twenty percent, unless otherwise specified in the Import/Export Policy 1992-97.[87] A unit may also act as both a domestic and export-oriented unit, but it must maintain separate accounts and have separate identities; however, separate legal identities are not required.[88]

The EOUs are eligible for many of the same benefits offered to units in the Free Trade and Export Processing Zones. However, they are also offered many additional benefits, such as permission to achieve 100% exports in an agreed upon phase, which the Board may relax on a merit basis if the exports are at least five percent of production. EOUs may take advantage of a consecutive five year tax holiday, taken at the Unit's option during the first eight years of operation, if the EOU is established in a zone. Certain approved units are issued cards for identification purposes, which entitle them to specific enumerated benefits (entitled "Green Cards"). EOUs are considered essential

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83. Other incentives include: a supply of power and good quality water assured at reasonable rates; all excisable goods produced or manufactured in a zone are exempt from any duty they would otherwise be liable to under the Central Excise and Sales Act; goods obtained from the domestic tariff area, which would normally be subject to excise, used by the industries within the zone for, or in connection with, production of goods intended solely for export are exempt from excise duties and other levies; the zones have all other infrastructural facilities; and units within the zones are typically entitled to complete tax holidays for a certain number of years, and to full reimbursement of central sales tax paid on their purchases made from domestic tariff areas on items used in the production of goods intended for export. *Id.* at 40-41.

84. *Id.*

85. *Id.* at 42.

86. *Id.*

87. *Id.*

88. *Id.*

consumers in areas such as power, iron and steel, giving them higher priority.

Finally, these Units have priority for release of foreign exchange, in which the Reserve Bank disposes of their applications within four days.[89]

The EOUs, Export Processing Zones, and Free Trade Zones are important tools that an investor should consider in determining how to structure an investment in India. They allow foreigners to make 100% investments in large, medium and small export-oriented industries.[90] In addition to the other benefits India offers foreign investors, such as low cost technical labor resources, investors in these zones also receive cheap land, import entitlements of raw materials and technology, and tax and other financial incentives. They also receive priority on loans, transportation of goods, and supply of cement and power.[91] In sum, a rather attractive package indeed!

VII. ENTRY STRATEGIES FOR FOREIGN DIRECT INVESTMENT IN INDIA

Foreign direct investment is the acquisition of ownership of a business or organization in a foreign nation.[92] Typically, an investor may accomplish this in one of three ways: (1) an investor can establish a new branch or subsidiary; (2) an investor can acquire the controlling share of an existing firm; or (3) an investor can participate in a joint venture.[93] In addition to the investment of capital, FDI involves the transfer of technology and business expertise, as well as access to a global market.[94]

In most industries, any of the above strategies may be used by a foreign company to invest in India. Indian law distinguishes a "corporate body," which is a company incorporated outside of India and includes both the Indian and foreign company, from a "company," which is an entity registered under the Companies Act and refers only to the Indian company.[95] A corporate body, or foreign company, must also comply with the Companies Act of 1956 and must register themselves with the Registrar of Companies (ROC) within thirty days of setting up its place of business in the country.[96] Most foreign investors use a company incorporated in India as their form of business.[97] Once incorporated

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89. *Id.* at 42-43.

90. *Id.* at 45.

91. *Id.*

92. James D. Nolan, Note, *A Comparative Analysis of the Laotian Law on Foreign Investment, the World Bank Guidelines on the Treatment of Foreign Direct Investment, and Normative Rules of International Law on Foreign Direct Investment*, 15 ARIZ. J. INT'L & COMP. L. 659, 663 (1998).

93. *Id.*

94. *Id.*

95. PRICE WATERHOUSE, *supra* note 15, at 83.

96. SEC'Y FOR INDUS. ASSISTANCE, INDIAN MINISTRY OF COMMERCE AND INDUS., ENTRY STRATEGIES FOR FOREIGN INVESTORS, *at* http://siadipp.nic.in/policy/entry.htm (n.d) (last visited Mar. 22, 2005) [hereinafter SIA].

97. PRICE WATERHOUSE, *supra* note 15, at 83.

and registered in India, the company will be subject to the same regulations as a domestic company.[98] Foreign ownership in these companies can be up to 100% depending on the business plan, the prevailing investment policy of the government, and the receipt of the required approvals.[99] A company can be either a public or private company as determined by its articles of association.[100] There are generally no restrictions on the residency or citizenship of the board members, and employee representation on the board of directors is not compulsory.[101]

A foreign company can also operate in India by creating a joint venture with an Indian partner. A joint venture may provide advantages to the foreign company, such as access to the established distribution and marketing process of the Indian partner, use of the partner's financial resources, and access to the Indian partner's contacts, which can help streamline the process of setting up operations in a foreign country.[102] However, since joint ventures are usually formed for very specific and limited purposes, they are not prevalent in practice.[103]

One other possible strategy for a foreign company is to set up a liaison office in India. This strategy is used to collect information about possible market opportunities and to provide information about the home company and its products to potential Indian consumers.[104] A liaison office is not allowed to conduct any trading or commercial activities in India other than collecting and transmitting information to the foreign company; thus, it cannot receive any income in India.[105] The opening and operation of a liaison office must comply with the regulations in the Foreign Exchange Management Act of 1999 (FEMA). Approval of the RBI is required to open this type of office, and the Indian government has imposed standard conditions for it.[106] For example, the

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98. SIA, *supra* note 96.

99. *Id.*

100. The Companies Act provides that a private company is deemed a public company if any of the following conditions are met:

1. One or more corporate bodies hold twenty-five percent or more of its paid-up share capital. (For this purpose, foreign companies are not considered corporate bodies.)
2. It holds twenty-five percent or more of the paid-up share capital of a public company.
3. Its average annual turnover is above a prescribed amount (at present rupees ten million).

PRICE WATERHOUSE, *supra* note 15, at 84.

101. However, government approval is required for the terms of appointment of expatriates as either full-time managers or board members if the expatriate's stay in India prior to appointment is less than one year. *Id.* at 90.

102. SIA, *supra* note 96.

103. PRICE WATERHOUSE, *supra* note 15, at 83.

104. SIA, *supra* note 96.

105. *Id.*

106. Permission to set up such offices is initially granted for a period of three years; however, this may be extended from time to time. The Liaison office must also file an annual

expenses of the liaison office are to be satisfied by the foreign company's inward remittance of foreign capital, and the office should not charge or receive any income from Indian consumers for the liaison services.[107]

A foreign company may also set up a temporary site office in India if it is planning to execute a short-term project in the country. The specific purpose of the project must be approved by the RBI, but permission is usually granted where projects are financed by an Indian bank or financial institution, or by a multilateral or bilateral international financial institution.[108]

With the exception of airlines, shipping and banking companies, which were allowed to open branch offices on a reciprocal basis in the past, branches of foreign companies have been asked to convert into Indian corporations. This requires a certain percentage of Indian participation in the equity of the company, based on the nature of the business.[109] As a result of this policy, branch offices had almost ceased to exist in India, and foreign companies were limited to liaison or site offices. The government has expanded the permissive approval of branches; now a foreign company engaged in manufacturing or trading activities abroad can also set up a branch office in India.[110] However, the purposes of these branch offices do have some limitations.[111] The branch office is not allowed to carry out manufacturing activity directly, and permission from the RBI to set up a branch office is granted on a case-by-case basis.[112]

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activity certificate, or something similar from a Chartered Accountant to the RBI. *Id.*

107. *Id.*

108. *Id.*

109. PRICE WATERHOUSE, *supra* note 15, at 83.

110. *Id.*

111. Branch offices for foreign manufacturing and trading companies can be opened for the following purposes:

> a. to represent the parent company or other foreign company in various matters in India, like acting as a buying or selling agent in India;
>
> b. to conduct research work in the area in which the parent company is engaged, [*provided the results of the research are available to Indian companies*];
>
> c. to conduct import and export trading activities;
>
> d. to promote possible technical and financial collaborations between Indian and overseas companies;
>
> e. to render professional or consultancy services;
>
> f. to render services in information technology and development of software in India; and
>
> g. to render technical support to the products supplied by the parent or foreign companies.

SIA, *supra* note 96.

112. "RBI normally considers the operating history of the applicant company worldwide and its proposed activities in India for granting the approval." Confederation of Indian Industry, http://www.ciionline.org/Services/74/default.asp?Page=Entry%20Strategies.htm (last visited Mar. 31, 2005).

VIII. THE GROWTH OF FOREIGN DIRECT INVESTMENT THROUGHOUT THE WORLD.

Throughout the history of international law, two conflicting views on foreign investment have emerged. The first view is entitled the "neo-classical theory," and its adherents believe that foreign investment is beneficial to developing states.[113] Under this belief, investment from more developed to less developed countries should be facilitated because it allows for the transfer of knowledge, skills, technology, capital, and employment.[114] Some proponents of this paradigm go as far as believing that "developing countries could not survive without multinational corporations and foreign investment."[115] The contradictory view, labeled the "dependency theory," holds that FDI is detrimental to a country's development and should not be encouraged.[116] Believers in the dependency theory argue that foreign investment is solely a means for a multinational corporation to circumvent a foreign country's regulations in order to serve the developed country in which they have their headquarters.[117] As a result, the developing country becomes dependent on the foreign investor, and in return for serving the interests of the home economy, the developing country gives up control and autonomy in determining its own policy.[118] It was belief in this theory that resulted in stringent restrictions, if not total prohibition, of FDI in developing countries up until recent history.

As a result of the more modern view towards FDI, there are few countries that engage in restrictive trade policies, because it is now generally understood that FDI is essential to keep one's economy from staggering. Countries now know that inward FDI plays an important role in increased exports and fast and sustained economic growth. "It is increasingly recognized that foreign direct investment (FDI) is an important component of an effective strategy to develop solutions to the global economic crisis, in part because it creates a flow of non-debt equity into developing countries and promotes sustained growth and employment."[119] Worldwide FDI has grown from $182.6 billion in 1995 to $865.5 billion in 1999,[120] of which developing countries received nearly $200 billion, an increase of 15%.[121] This growth seems to be increasing at an even faster rate now; in 2000, FDI inflows may have exceeded $1.1 trillion, over

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113. Nolan, *supra* note 92, at 664.
114. *Id.*
115. *Id.*
116. *Id.*
117. *Id.* at 664-65.
118. *Id.* at 665.
119. Daniil E. Fedorchuck, *Acceding to the WTO: Advantages for Foreign Investors in the Ukrainian Market*, 15 N.Y. INT'L L. REV. 1, 2 (2002).
120. *Id.* at 6-7.
121. Kevin C. Kennedy, *Global Trade Issues in the New Millennium, Foreign Direct Investment and Competition Policy at the World Trade Organization*, 33 GEO. WASH. INT'L L. REV. 585, 597 (2001) [hereinafter *Global Trade Issues*].

14% of the FDI in 1999.[122] Further, the number of bilateral investment treaties and double taxation treaties has increased, reflecting the "growing role of FDI in the world economy and the desire of countries to facilitate it."[123] There are predictions that FDI will continue to play an important role in the world's economic system, as globalization and cross border expansion is likely to increase in the future.[124]

These changes are a result of the transformation that developing countries have encountered as they have gone from being hostile towards FDI in the 1960s and 70s to actively pursuing it in the late 1980s and 90s. The hostility in the 1960s and 70s was partially a result of large multinationals expanding abroad and opening new plants by acquiring locally-owned enterprises.[125] This concern caused developing nations to adopt fairly common approaches to regulate foreign investment. First, developing nations either severely limited or prohibited acquisition of host nation enterprises.[126] Second, any new investments permitted were required to own certain percentages of local equity participation. For example, some areas of investment would typically be reserved exclusively as state owned enterprises, and areas that allowed investment required that the foreign equity percentage be capped at forty-nine percent.[127] The investment that was allowed would have to be approved by a government agency, which usually had discretion in granting exceptions.[128] Most concerning for potential investors, however, was that many of the restrictions were unwritten and created transparency issues for the unknowing investor. These "drawer regulations" would be enacted after the investor had spent considerable time and money in research and preparation on the investment. With no concise written laws, one cannot truly determine if a financial contribution toward a project in another country is attractive, as regulations such as tax and labor laws that affect the return are unknown. As a

122. Fedorchuck, *supra* note 119, at 7.

123. Kennedy, *supra* note 121, at 597.

124. Fedorchuck, *supra* note 119, at 58.

125. RALPH H. FOLSOM ET AL., INTERNATIONAL TRADE AND INVESTMENT IN A NUTSHELL 179 (2000). This author refers to this result as Post Colonial Traumatic Syndrome (PCTS), describing the shock entities go through when they transition from following a definitive set of laws and policies dictated to them to creating laws to govern themselves. When a multinational company expands into a developing country, part of the investment includes a transfer of technology and management skills, which the company teaches the local workers. After a period of time the local content of labor is increased, and eventually the company is run by local management. PCTS may occur when the local management is unable to run the company as effectively as the foreign management, and creates policies that do more harm to the company than good. *See id.*

126. *Id.*

127. *Id.*

128. *Id.* Frequently, the agency followed a statute providing a list of criteria for approving foreign investment. Common criteria included agreeing on the number of workers to be employed, mandating the use of domestic materials and parts that would be used, requiring financing to be obtained from abroad, consideration of the effects on existing domestic businesses, and establishing research and development facilities in the nation. *Id.* at 179-180.

result, foreign investment is deterred from countries with drawer regulations and contributed instead to countries with automatic approval processes or concise and transparent investment laws. While many countries have tried to address this with investment codes and written regulations, this is still a concern when a government agency has discretion to allow an investment. Another common approach of developing nations has been to encourage or coerce existing foreign partners in joint ventures to sell majority ownership to local individuals, entities owned by local individuals, or the state.[129]

After several years of these restrictive rules, many developing nations began to wonder why nationals had not increased their rate of development. They began to realize that shifting ownership from foreign to local was not a guarantee of economic development in the nation as a whole.[130] As a result, these governments tried to encourage foreign investment by allowing substantially expanded foreign ownership under either written or unwritten exceptions to foreign investment laws.[131] For example, if the foreign investor transferred the most modern technology to the host nation or located its plant in a zone of high unemployment or one designated for economic development, exclusive ownership would be allowed.[132] In the 1980s and 90s, developing nations' attitudes towards foreign investment began to change even more dramatically. Many attribute this change to "(1) the debt crisis in the early 1980s, (2) the opening to investment by many *non*market economies, and (3) the election of less 'populist' governments in many developing nations."[133]

As a result of the frustration of the past, a new paradigm for foreign investment has emerged. The present trend in national legislation throughout the world since the 1980s is to adopt laws that create a favorable investment climate to attract foreign investors.[134] Many countries even go as far as offering super-national treatment to foreign firms, giving them incentives that are not available to domestic firms.[135] Joint ventures with local ownership are still encouraged, but are now voluntarily formed rather than compelled.[136] Also, many governments around the world are privatizing their previously state-

129. *Id.* at 181.

130. *Id.* at 183.

131. *Id.*

132. Other strategic areas where foreign investment would be totally allowed included those with a high export percentage of its output, or those where research and development facilities would be located in the nation. *Id.*

133. *Id.*

134. Kennedy, *supra* note 121, at 597.

135. SHANG-JIN WEI, WORLD BANK GROUP ET AL., CAN CHINA AND INDIA DOUBLE THEIR INWARD FOREIGN DIRECT INVESTMENT? 2, http://www.nber.org/~confer/99/indiaf99/India-China-FDI.PDF (Nov. 30, 1999) (last visited Mar. 22, 2005). For example, China offers benefits to foreign firms such as reduced taxes, or an elimination of them altogether, which are not offered to domestic firms. *Id.*

136. "Sometimes continuing restrictions on foreign ownership of land induces a joint venture, as might risk analysis which suggests limiting equity participation, even though market studies encourage entering the market." FOLSOM ET AL., *supra* note 125, at 184.

owned enterprises, opening new windows of opportunity for foreign investors.[137] Many developed countries have privatized almost all of these enterprises, even industries with a close relation to national security and government control of their nationals, and these former state-owned enterprises are no longer tied to a political arena.[138] Developing countries have also participated in the privatization process, but to a more limited extent. However, these developed countries have recently begun reassessing the potential for investment by the private sectors in areas of public services and physical infrastructure, and have actively been selling off state-owned enterprises.[139]

Developing and transitioning countries have also started adopting other liberalization policies in addition to privatization, such as deregulation and implementation of measures that safeguard effective competition. In fact, since 1990, over thirty-five developing countries have enacted or substantially revised their competition laws in efforts to become more attractive destinations for foreign direct investment.[140] Also, developing countries and non-market economies have reinterpreted their restrictive investment laws in favor of foreign investors and have subsequently replaced them with laws encouraging investment.[141]

One of the most successful examples of this transformation is China, which had practically zero foreign investment in the 1970s, but is now a major host country of FDI and the largest developing host country.[142] Investment in China has grown exponentially, as FDI in 1997 was 1,200% more than what it was in 1990.[143] China is obviously an attractive destination for FDI, and many consider it "the world's strongest magnet for overseas investment."[144] As a result of the increased FDI, China has experienced increased export expansion and significant overall growth.

Companies want to invest in countries where they can find low cost resources, such as labor. Countries are competing for the foreign investment dollar. So why has a country such as India, with a multitude of benefits for investors, including an open and liberal investment policy, not been able to succeed in attracting this foreign investment?

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137. Joseph C. Blasko, *Overcoming the Legal and Historical Obstacles to Privatization: The Telecommunications Sector in Thailand*, 30 CASE W. RES. J. INT'L L. 507, 507 (1998).

138. *Id.* at 508.

139. *Id.*

140. THE INT'L BANK FOR RECONSTRUCTION AND DEV. ET AL., A FRAMEWORK FOR THE DESIGN AND IMPLEMENTATION OF COMPETITION LAW AND POLICY V (1999).

141. FOLSOM ET AL., *supra* note 125, at 184.

142. WEI, *supra* note 135.

143. *Id.* at 4.

144. *Id.* at 2

IX. WHY INDIA HAS NOT ACHIEVED ITS POTENTIAL

Despite the multiple benefits mentioned above, India has not achieved its potential as an attractive destination for foreign investment. In the words of one expert, "India's investment climate is weak, limiting productivity gains and thus future growth and poverty reduction."[145] This type of climate imposes high costs on firms, which lowers profits and deters new companies from investing in India. Foreign direct investment, as a share of the gross domestic product (GDP), was less that one percent in 2002 and 2003 in India, while representing four percent in China, and anywhere between two to three percent in many other emerging markets.[146] "[I]n many areas India lags behind other emerging market economies, and if it could achieve Chinese or Thai levels in distinct investment climate areas, its growth acceleration would be even more dramatic."[147]

X. INDIA'S ECONOMIC HISTORY

In order to appreciate India's treatment of foreign investment, it is important to understand India's economy. India was invaded by Europeans, primarily the English, who arrived in the early seventeenth century. By the eighteenth century, India was forced, for the first time, into a subordinate role within a world system, based on industrial production rather than agriculture.[148] The English criticized India's past achievements and customs for lacking Western intellectual and technical aspects. The English tried to "civilize" India by importing these improvements.[149] In addition, the English felt it was their responsibility to govern India until Indians could rule themselves.[150] The

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145. Nicholas Stern, World Bank Group, Abstract: Public Finance and Policy for Development: Challenges for India, NIPFP Silver Jubilee Lecture, *at* http://lnweb18.worldbank.org/SAR/sa.nsf/Countries/India/7F6A6C684145A7FD85256B20002C4510?OpenDocument (last visited Mar. 22, 2005) [hereinafter Stern Abstract].

146. Carter, *supra* note 27.

147. In 1999, FDI inflows in India were 0.5% of GDP, as compared to FDI inflows in China at 3.9% of GDP, and Thailand at 5%. IMPROVING INVESTMENT CLIMATE, *supra* note 29, at 5.

148. James Heitzman & Robert L. Worden, *History of India essay*, INDIAN CHILD, Oct. 1, 1996, *at* http://www.indianchild.com/history_of_india2.htm (last visited Mar. 23, 2005).

149. FEDERAL RESEARCH DIVISION, U.S. LIBRARY OF CONGRESS, INDIA (2003), http://countrystudies.us/india/16.htm (last visited Mar. 31, 2005) [hereinafter INDIA].

150. The British Parliament enacted several laws in an effort to regulate India. Among them were:

> 1. The Regulating Act of 1773, which gave the British supervisory rights over the Bengal, Bombay, and Madras presidencies in an effort to bring order in territories under company control;
>
> 2. The India Act of 1784, which gave the Parliament greater control by establishing the Board of Control, whose members were selected from the cabinet; and

British implemented new models of mass production in India, which resulted in the suffering, and ultimately the destruction, of many of the craft and cottage industries that thrived prior to the British invasion.[151] While this regime worked well in England, arguably it resulted in the destruction of much of the culture and progress that India attained. Many institutions, such as universities and communication industries, were utilized to serve British economic interests rather than those of India.[152] As a result, "[a] country that in the eighteenth century was a magnet for trade was, by the twentieth century, an underdeveloped and overpopulated land groaning under alien domination."[153]

India did inherit some positive changes from England, however. Throughout the 1850s, the British introduced three "engines of social improvement": the railroad, the telegraph, and a uniform postal service.[154] These advancements made communication between rural and metropolitan areas easier and faster and facilitated the transportation of raw materials and goods from one part of the country to the other. Nonetheless, while India was left with a number of resources from the British raj, these resources were wrapped in a cocoon-like bureaucracy.

India gained political independence from Great Britain in 1947 and sought to gain financial independence as well. The Indian government adopted an autonomous policy in an attempt to improve the Indian economy, and was not amenable to foreign trade.[155] India placed strict controls on imports and

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3. The Charter Act of 1813, which recognized the British moral obligation of enacting just and humane laws in India.

Id. Also, in an attempt to make the Indian business climate more professional, the governor-general, Charles Cornwallis, changed the business structure. He separated commercial and administrative functions, declared private trade among company employees illegal, and compensated company servants with generous salaries. In an effort to increase revenues, two systems were created. *Id.* The first was the Permanent Settlement system, or *zamindari* system, in which taxes were fixed in return for ownership of large estates. In this system, however, the state was precluded from expanding the agricultural sector. The second system was the peasant settlement system, or *ryotwari* system, under which peasant farmers had to pay annual taxes directly to the governments. *Id.* Neither of these systems worked, however, creating greater stratification between the classes. More and more people began to rely on agriculture for survival as they lost their jobs and lacked any other opportunities for employment. *Id.* The British felt it was their duty to educate the Indians by teaching them literature and culture from England. Unfortunately, this effort had the result of reinforcing the stratification among the different classes, as the western-educated, Hindu elite initiated many reforms in response to government policies, the poorer, peasant Muslims failed to do so. As a result, the British left India in a state of turmoil, and despite their efforts, England was unable to make India respond to a system that did not suit their country. *See generally id, at* http://countrystudies.us/india/ (last visited Mar. 31, 2005).

151. Heitzman & Worden, *supra* note 148.

152. *Id.*

153. *Id.*

154. INDIA, *supra* note 149, *at* http://countrystudies.us/india/16.htm.

155. *See id. at* http://countrystudies.us/india/21.htm (last visited Mar. 31, 2005). India was sensitive to foreign domination; fearful that something similar to the Raj would occur again, and as a result, adopted these protective governmental policies, even once the period of colonialism had ended. *See id. at* http://countrystudies.us/india/94.htm.

exports, and essentially isolated itself from the global market. Foreign investment in the private sector was tightly regulated, and it was believed that public ownership of basic industries was necessary to guarantee development in the interest of the whole population.[156] Indian officials believed that trade was biased towards developing countries, so their policy was aimed at self-sufficiency in most products through import substitution, with only the cost of residual import requirements covered by exports.[157] The government ensured a marginal and highly circumscribed role of FDI in the country by developing strict control under the Foreign Exchange Regulations Act (FERA) and the Monopolies and Restrictive Trade Practice (MRTP).[158] The FERA capped foreign equity participation at forty percent in order to control foreign exchange outflows arising out of dividend and royalty payments.[159] The MRTP discouraged large enterprises from being developed, and as a result, prevented economies of scale from being realized.[160]

Accordingly, India played a relatively small role in the world economy, and its relative importance declined. Its share of world trade shrank from 2.4% in 1951 to 0.4% in 1980.[161] India tried to generate the foreign exchange it needed from the import of oil and high-technology capital goods by emphasizing exports throughout the 1980s.[162] However, in the early 1990s India's share of world trade still stood at only 0.5%.[163] India was politically and economically unstable, and the international community lost confidence in India's economic viability. Consequently, India was forced to liberalize its economic policy and open its doors to foreign investment.[164] To achieve this liberalization, the Indian government introduced the New Industrial Policy in July of 1991, which, as previously discussed, greatly relaxed regulations on foreign investments.

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156. *Doing Business in India – India Trade*, INDIAN CHILD, *at* http://www.indianchild.com/india_trade.htm (last visited Mar. 31, 2005) [hereinafter *Doing Business in India*].

157. *Id.*

158. KISHOR SHARMA, ECON. GROWTH CTR., YALE UNIV., EXPORT GROWTH IN INDIA: HAS FDI PLAYED A ROLE? 4, http://www.econ.yale.edu/growth_pdf/cdp816.pdf (July 2000) (last visited Mar. 23, 2005).

159. *Id.* at 4.

160. *Id.* The MTRP controlled the expansion and structure of large businesses in an effort to prevent the concentration of economic power and to curb restrictive policies. *Id.*

161. *Doing Business in India*, *supra* note 156.

162. *Id.* The Indian economy improved somewhat in the early 1980s, primarily due to investments made by Indian citizens. However, these funds were limited and eventually the government was forced to turn to foreign aid to stimulate growth, resulting in a severe deficit. In addition, the central government fell, creating political instability. Jatana, *supra* note 15, at 332.

163. *Doing Business in India*, *supra* note 156.

164. Jatana, *supra* note 15, at 332.

XI. THE EFFECTS OF THE REFORM POLICY IN 1991

The reform program in 1991 improved the FDI inflows in India, and when compared to the country's past performance, the program has proven to be a boon for the country. For example, FDI inflows increased from approximately USD one billion during the 1980s to USD 9.8 billion during the 1990-97 period.[165] Also, the percentage of FDI in the GDP grew from about 0.2% during the 1970s and 80s to over 3% in 1997. By then, India had become the ninth largest recipient of foreign direct investment by developing countries.[166] The Industrial Policy of 1991 also had a positive effect on the GDP. After the reform program, GDP growth went from 5.5% per year in the 1980s to an average growth of 6% in the 1990s, peaking in 1996-97 at 7.8%.[167] One of the main reasons for this increased growth was the increase in private investment, which grew at a rate of 20% per year in real terms from 1992-93 to 1996-97.[168]

While these factors indicate a positive trend for investment in India, one might still contend that the investment climate in India is far from satisfactory and has not achieved its potential. Indeed, the growth in private investment has slowed by 3.4% per year for the period 1997-98 to 2001-02.[169] India's GDP growth has also slowed to an average of 5.75% per year from 1997 to 1998.[170] "Although such growth is high by international standards, the deceleration of private investment and growth has emphasized the need for what Indian policy-makers are calling 'second generation reforms'."[171] Also, there is a huge difference between the levels of approved and actual FDI. In January 1999, actual inflows of FDI were USD sixteen billion, less than thirty percent of the approved USD fifty-four billion.[172] In the words of a respected economist, "the system just does not work as it is supposed to. The rules may be liberal in principle . . ., [but] delays, complexities, obfuscations, overlapping jurisdictions and endless request for more information remain much the same as they have always been."[173] In addition, one of the greatest disappointments from India's economic development plan has been the failure to reduce the country's widespread poverty levels. As of mid-2003, about 260 million Indians lived below the poverty line.[174]

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165. SHARMA, *supra* note 158, at 7.

166. *Id.*

167. IMPROVING INVESTMENT CLIMATE, *supra* note 29.

168. Carter, *supra* note 27.

169. *Id.*

170. IMPROVING INVESTMENT CLIMATE, *supra* note 29.

171. *Id.*

172. SHARMA, *supra* note 158, at 8. This is even lower in the infrastructure sector, where only sixteen percent of the cumulative approvals converted into actual investment. In the telecommunications sector the rate was fifteen percent, and in the oil refining sector it was eleven percent. *Id.*

173. *Id. Quoted in* ECONOMIST, Feb. 22, 1997, at 8.

174. Carter, *supra* note 27. The government's poverty line is based on an income that

XII. INEFFICIENCIES

There are many possible explanations for the aforementioned slow down in growth. As discussed above, India is well positioned with determinants such as its local market size and its vast supply of well-educated, low-cost workers. When these factors are emphasized in comparing FDI competitiveness, India ranks near the top of the list.[175] However, India's potential competitiveness is offset by investment climate bottlenecks.[176] One indication of a country's competitiveness is the productivity dispersion of firms that operate there. Higher dispersion levels show that less efficient producers are not being forced to become more productive, usually because the producer is receiving subsidies or other protection from the government.[177] This reduces the incentive for efficient producers to increase their productivity or to expand because their competition is being subsidized for less production.[178] A liberal and open trade policy makes markets competitive, challenging domestic monopolies, while at the same time ensuring against possible abuses by foreign investors.[179] India, however, has a very high productivity dispersion ratio, higher than that of other East Asian countries, which indicates that there is room to increase competition in India, forcing less productive firms to either become more efficient or shut down.[180]

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would be sufficient to be able to satisfy minimum nutritional standards. As a result, most people above the poverty line in India have low levels of consumption compared to the rest of the world. *Id.*

175. IMPROVING INVESTMENT CLIMATE, *supra* note 29. "A.T. Kearney publishes an index of FDI competitiveness that combines these elements, with an emphasis of market size and labor costs. India ranks near the top of the list at number 7." *Id.*

176. *Id.*

177. *Id.*

178. *Id.* As competition is increased in a country due to additional firms and an influx of more efficient businesses, the local firms have a greater incentive to improve their productivity.

> Loss of protection and greater competition from foreign firms can drive inefficient domestic producers to better exploit scale economies, eliminate waste, reduce managerial slack or 'x inefficiencies', adopt better technologies or shut down. As a result, productivity dispersion should shrink as productivity levels rise in the face of greater competition.

Id.

179. Kennedy, *supra* note 121, at 599.

> The implementation of a transparent and effective competition law and policy can be an important factor in enhancing the attractiveness of an economy as a site for foreign investment and in maximizing the benefits of foreign investment. Likewise, local firms will have the same ability to prevent abuses by foreign investors through a transparent and effective competition law and policy.

Id.

180. IMPROVING INVESTMENT CLIMATE, *supra* note 29. In textiles, garments, and electronics, India has a dispersion ratio of approximately five, while in Korea the ratio is just over two, and the ratio in Malaysia and Thailand are just under three. *Id.*

XIII. EXCESSIVE REGULATIONS AND CORRUPTION

One reason the competitive environment has not improved in India is that efficient firms do not want to deal with what they perceive as excessive regulations for entry and exit. Despite the government's valiant efforts to simplify investment procedures, India remains a maze of restrictive laws and policies.[181] As a result, India still has longer median days and higher permit requirements than most other countries.[182] There are many examples of hurdles that foreign businesses have had to face in order to invest in India. One such example, given by the Confederation of Indian Industry, is that of a typical foreign power project. It is reported that such a project needed forty-three clearances from the central government, as well as an additional fifty-seven at the state level.[183] One can easily argue that this cumbersome system resulted in a cumulative rate of approved foreign investment that was actually realized at the rate of only twenty-five percent between 1991 and 1999.[184]

Excessive regulation and corruption are also detrimental to India's attempt to attract foreign investment money. "One of the most discouraging and enduring characteristics of investing abroad, in nonmarket as well as developing nations, is persistent and deeply rooted corruption. Government officials view openings to foreign investment as an opportunity to 'cash-in' on the enormous amounts of funds changing hands."[185] Studies have shown that countries with high levels of corruption and red tape receive less foreign investment from all major source countries, especially from the United States.[186] One subjective corruption index rated India 7.1 and China 6.5 on a scale of zero to ten, with ten being the most corrupt.[187] Both countries also have high bureaucratic burdens, further worsening their investment climates; India has a rating of 5.1 and China is rated at 4.58 on a scale of one to seven.[188]

While these cross-country indicators rank India close to China in terms of corruption and rule of law, there are other objective measures that capture other costs not reflected in these indicators. For example, in looking at the amount of time plant managers in India spend dealing with government officials, India

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181. FOLSOM ET AL., *supra* note 125, at 184.

182. IMPROVING INVESTMENT CLIMATE, *supra* note 29. "Relative to China, starting a business in India requires 10 permits compared to 6 in China, and the median time is 90 days in India relative to 30 days in China." *Id.*

183. *Id.*

184. *Id.*

185. FOLSOM ET AL., *supra* note 125, at 184.

186. WEI, *supra* note 135, at 3. This is mainly considered to be a consequence of the United States Foreign Corrupt Practice Act (FCPA), which confronts U.S. investors, and until 1999 made the U.S. the only source country in the world that penalizes its firms for bribing foreign governmental officials. *Id.*

187. *Id.* This is compared to 0.9 in Singapore and 4.7 in Malaysia. This index was completed by Transparency International. *Id.*

188. *Id.* In comparison, Singapore had a rating of 2.08 and Malaysia had one of 3.63. *Id.*

ranks less favorably than most other developing countries.[189] One other regulatory obstacle for businesses in India is dealing with customs officials. This problem has two components: the average delay in goods being cleared and the variances in clearance time. The average clearance time is about fifty percent longer in India than in Korea and Thailand. More importantly, however, is the variance in delays, as this uncertainty forces firms to keep a greater inventory of materials on hand.[190] This manifests itself as an "additional tax" on businesses because they incur interest and storage costs and tie up resources that could be used more productively.[191] In addition to the bureaucratic burden of clearing goods through customs, firms in India also have to deal with corruption in the Indian government. Approximately ninety percent of firms in India make irregular payments to government officials.[192] This rate is similar to the rates found in Thailand and Indonesia, but is almost twice the rate in Malaysia.[193] While this imposes additional costs on businesses looking to operate in India, it is not necessarily much of an impediment to them. "If there is little uncertainty regarding the size of the payments and if the payments do secure the desired services, many report that the corruption is not much of a problem."[194]

XIV. FINANCIAL MARKETS

Another reason foreign businesses are reluctant to invest in India is the number of problems associated with its financial markets. While India has a vibrant financial market with over 9,000 listed companies,[195] it also has problems, such as high interest expenses, excessive collateral requirements, and burdensome paperwork.[196] As a result, firms have limited access to expensive loans even though the country has a very high level of savings.[197] When compared to other firms, Indian firms have a higher percentage of their costs going to interest. For example, in 2002 both China and India were environments of low inflation. India's interest rate on loans was 12.3%, much

189. IMPROVING INVESTMENT CLIMATE, *supra* note 29. Indian mangers spend about sixteen percent of their time dealing with the government, while in China it is close to nine percent; in Latin America, it is about eleven percent, and in transitional Europe it is about twelve percent. This represents a relative weakness for India, as the opportunity cost for mangers' time is quite high. *Id.*

190. *Id.* In India, the longest delay for a typical business was twenty-one days, while in China it was only twelve days. *Id.*

191. *Id.*

192. *Id.*

193. *Id.*

194. IMPROVING INVESTMENT CLIMATE, *supra* note 29. The frequency of payments (i.e., bribes) to Indian officials is seen as less of a burden than the time spent dealing with government regulators and agencies. *Id.*

195. Indian Inv. Ctr., *supra* note 9.

196. IMPROVING INVESTMENT CLIMATE, *supra* note 29.

197. *Id.*

higher than China's at 5.9%.[198]

XV. LABOR REGULATIONS

One of the greatest challenges of doing business in India is the restrictions on hiring and firing workers. As reported by a reputable international news source, "India has rigid labour laws that make it almost impossible to fire an employee or hire contract labour. That is one reason India attracts roughly a tenth as much foreign direct investment as China."[199] For a firm to be competitive, it has to be able to allocate its resources, including its workforce, in the most efficient way. This is essential for a firm to realize the benefits of greater competition and openness. The restrictions imposed on firms doing business in India regulating the hiring and firing of workers has resulted in the reluctance of firms to take on new employees. In fact, the typical firm in India has reported that it employs seventeen percent more workers than it desires, and that it is unable to adjust to the optimal level of workforce because of the Indian labor regulations.[200] As a result, in this critical area India ranks seventy-third out of seventy-five countries in global competitiveness, a staggering position when compared to China at twenty-third.[201]

In addition to the added expense of employing more workers than necessary, Indian companies also face more costs than China as a result of higher wages and reduced productivity. While Indian wages are low compared to developed countries, in fact they are one of the main reasons companies outsource labor there, China's manufacturing wages are even lower.[202] Chinese workers also offer higher productivity in consumer goods than Indians. It is estimated that an average Indian worker produces at about one-quarter of the efficiency of that of an average Chinese worker.[203] The enormity of such a statistic is hard to disregard.

XVI. COMPARISON TO CHINA

China and India, the two dominant powers in mainland Asia, have many similarities. They both have common advantages, such as diverse populations of over one billion people and seemingly limitless economic potential. Both China and India also made the transformation from being hostile to FDI in the 1970s to now encouraging it. The countries also share many problems, such as

198. *Id.*

199. James Kynge & Edward Luce, *India Starts to See China as a Land of Business Opportunity*, FINANCIAL TIMES, Sept. 23, 2003.

200. IMPROVING INVESTMENT CLIMATE, *supra* note 29.

201. *Id.*

202. Kynge & Luce, *supra* note 199.

203. *Id.* The consulting firm McKinsey published a recent report stating that on average an Indian worker produces about three shoes per day, while a Chinese worker produces about eleven per day. There was similar productivity dispersion for textiles and ceiling fans. *Id.*

mass poverty, oppressive bureaucracies, and widespread corruption.[204] Yet, despite their many similarities, China has transformed into a super-magnet for FDI while India lags significantly behind.[205] In the words of one financial writer, "While the sleeping giant that was China has woken with a vengeance, India still appears to be quietly dozing in the corner."[206] In sum, although both countries now see FDI as an important aspect of economic growth, they face different challenges in realizing this goal.

India started its open door policy later than China, which adopted its open door policy in 1979.[207] As a result, China has been the largest developing host country of FDI and the second largest country overall ranking, only behind the United States for the last few years.[208] India, on the other hand, has an FDI total that is less than one-tenth of that of China.[209] While India started a decade later than China, when it decided to amend its laws, India chose to liberalize much more quickly. China, of course, opened its policy with the typical characteristic of caution.[210] One other reason for the difference between Indian and Chinese investment levels may very well be the laws and regulations that China has drafted to specifically attract foreign investment. One example of this is the offering of super-national treatment to foreign firms, giving benefits that are not even offered to Chinese domestic firms.[211] India has not offered comparable super-national tax treatment as of yet.

In addition to the above differences in regulatory policy, there are other possible explanations for the disparity between Indian and Chinese FDI inflows, such as the unusual composition of source countries sending foreign investment to China. The United States, Japan, Germany, France and the United Kingdom were the world's five most important source countries in terms of FDI outflow during the period of 1990 to 1995, according to the United Nations.[212] In fact, collectively they accounted for seventy percent of all

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204. *See* John Thornhill, *China's Challenge*, FINANCIAL TIMES, Apr. 12, 2002 (assessing whether Beijing's success will force it to embrace economic reform).

205. WEI, *supra* note 135.

206. Thornhill, *supra* note 204.

207. WEI, *supra* note 135 at 6. "Under Deng Xiaoping, the promulgation of the 1979 'Law on Chinese-foreign equity joint ventures' together with the establishment of four special economic zones formally signaled the adoption of the 'open-door' policy by the central government." *Id.*

208. *Id.* at 2.

209. *Id.*

210. *Id.* at 6-7. China first allowed only equity joint-ventures or contractual joint ventures, and foreign exchange was tightly regulated. The Chinese government did not allow any wholly-owned foreign firms. There was also a tight export performance requirement, sometimes up to 100%. However, these restrictions have been relaxed over time, and now the annual inflow to establish a wholly-owned firm is greater that the inflows for a contractual joint venture, and is close to that of an equity joint venture. *Id.*

211. *Id.* at 7. For example, foreign firms may receive an income tax exemption for the first two profitable years, followed by a fifty percent tax reduction for three additional years. *Id.*

212. Thornhill, *supra* note 204, at 8. Since the major source countries avoid corruption and regulatory burdens, many invest heavily in Hong Kong as a stepping stone to investing in

FDI coming from developed countries.[213] Hong Kong, however, is the dominant source of FDI in China, accounting for at least half of the total FDI into China for every year between 1992 and 1997.[214] The United States and Japan were typically the second and third largest investors in China, but they invested less than twenty-five percent of the Hong Kong investment.[215] Therefore, if one excludes the "false-foreign" and "quasi-foreign" direct investment, the true foreign direct investment would be about fifty percent of what is reported.[216]

One other reason for the difference in FDI in India versus that in China is that the Chinese data may be overstated. For example, in 1996 and 1997, the Chinese source claims to have received investment from the United States in the amount of USD 3.4 billion and 3.2 billion respectively. The United States' source, however, reported only USD 0.9 billion and 1.2 billion respectively.[217] This data may be overstated due to the government's incentive to exaggerate China's ability to attract FDI, but there may be other reasons as well.[218] Either way, the investment from Hong Kong and over-reporting of Chinese inflows exacerbate the theoretical discrepancy between foreign investment in India versus that of China.

In the manufacturing sector, China has outperformed India; Chinese-made televisions, air conditioners and cellular phones appear in stores

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Mainland China. This may increase the amount of investment in China, as Hong Kong may invest in China on behalf of the major source countries. *Id.*

213. *Id.*

214. *Id.*

> One may question whether Hong Kong's investment in Mainland China should be counted as foreign direct investment. This is particularly so since July 1, 1997, Britain has formally turned over the territory back to China. In that connection, one can at most treat investment coming from Hong Kong as quasi-foreign.

Id. Also, part of the Hong Kong investment may include investment from Taiwan, which is disguised to avoid political inconvenience with the Taiwanese government. This part of the Hong Kong investment should also be treated as quasi-foreign investment. *Id.* at 8-9.

215. *Id.* at 8.

216. *Id.* at 9. "False-foreign" investment includes "round-tripping," a term explaining part of the FDI from Hong Kong, which is actually capital that originates in Mainland China and comes back to Mainland China disguised as Hong Kong investment in order to take advantage of tax, tariff, and other benefits granted to foreign-invested firms. *Id.*

217. SHANG-JIN WEI, CENTER FOR RESEARCH ON ECONOMIC DEVELOPMENT AND POLICY REFORM, WORKING PAPER NO. 85 SIZING UP FOREIGN DIRECT INVESTMENT IN CHINA AND INDIA 10 (1998), http://scid.stanford.edu/pdf/credpr85.pdf (last visited Mar. 31, 2005); *see also* WEI, *supra* note 135. "Generally speaking, the Chinese-reported inflows were much greater that the source countries' own reporting for FDI from the United Kingdom, France, Australia, and Italy as well." Thornhill, supra note 204, at 11. German and Japanese reported numbers were similar to the Chinese reports. *Id.* However, Japan reports approval values, which are generally higher than actual values, and German firms are only required to report their investment levels if they hold more than twenty percent of the voting rights or shares in a foreign enterprise. Thus, there is a possibility that the investment from these two firms may still be overstated in Chinese reports. *Id.*

218. *Id.* at 11. For example, the OECD benchmark may be understated, due to items such as reinvested dividends not being properly counted. *Id.*

worldwide and goods made in India are rarely seen on the market.[219] While India offers a massive internal consumer market, it is secondary to China. As a result, Chinese companies have economies of scale larger than their Indian competition. Regardless of the industry, China's market is about three to four times the size of India's.[220] According to observers, "Whether it is China's cheaper, more reliable power supply, its higher rate of literacy, or the more rapid turnaround at its ports, China remains an incalculably better environment for most manufacturing than India, which is slowly waking up to this."[221]

Even the advantages India has in the service sector, due to the vast amounts of business-process outsourcing, have started declining, giving China the opportunity to overcome India's gains here as well. China's government has been investing heavily in the human capital needed for the country to develop its own software industry. While China does not boast the vast English-speaking community that India does, it has a steady stream of new graduates who not only speak English, but excel in other Asian languages, such as Japanese and Korean.[222] Also, as Indian wages are starting to increase, outsourcers are looking to more affordable options like China.[223] Even though India still holds the advantage in software development and white-collar outsourcing, it is not unreasonable to imagine China as closing in on India's power. It is estimated that India has only a few years to improve its investment climate if it is to maintain its lead in this industry.[224]

Oddly enough, many feel that China offers a more politically stable environment than India.[225] "China offers the sort of quiet stability that India – with open hostility toward Pakistan sparking nuclear-war threats every few years – doesn't."[226] It has been suggested that India is too democratic to succeed, while China's autocratic methods have proved effective in enforcing labor discipline, implementing industrial policies, and directing capital into

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219. Bruce Einhorn, *The Quest for Asia's Outsourcing Crown*, BUSINESSWEEK ONLINE, July 30, 2003, *at* http://netscape.businessweek.com/technology/content/jul2003/tc20030730_9305_tc058.htm (last visited Mar. 23, 2005).

220. Kynge & Luce, *supra* note 199. However, in areas of manufacturing that require high technology inputs, India has the advantage and has even been exporting these goods to China. For example, one auto components manufacturer, based just north of Mumbai, exported about forty million dollars worth of car parts to China in 2002. *Id.* The CEO of the company said that they have the advantage over their competition in China because their manufacturing is very technical and they have an easier time hiring technologists and engineering graduates than companies in China. *Id.*

221. *Id.*

222. Einhorn, *supra* note 219.

223. *Id.*

224. *See id.*

225. *Id.* Even though China is the last surviving communist power and India is the largest democracy in the world, many see India as a less stable economy. *Id.* Even more strange is that this is true despite that China has unelected officials who tried to cover up the SARS outbreak up until it became a worldwide crisis. India, on the other hand, has an open economy and free press, making access to information easy. *Id.*

226. *Id.*

export-oriented industries.[227] With businesses intending to remain in the country for at least ten to twenty years, executives look for a very stable environment to minimize political risk.[228]

Despite the aforementioned advantages, some have characterized both countries as underachievers in foreign investment. Both countries started with an extraordinarily low level of FDI before changes in government policy welcomed FDI. As a result, while China may be seen as a super-magnet for FDI in annual flows, its stock of FDI still has not reached its potential.[229] The gap between actual inflows and potential inflows is larger for India than for China, but both countries are considered underperformers, even if one only looks at the inflows.[230] Indeed, corruption and regulatory burdens remain a major deterrent on inflows of FDI in both countries. So while China is seen as an attractive destination for FDI, its absolute values are apparently overstated and remain low compared to its potential.[231] Thus, in the competition for the foreign dollar, India should recognize that China is formidable, but at the same time vulnerable, to strong competition.

XVII. RECOMMENDATIONS TO ACCELERATE THE RATE OF FOREIGN INVESTMENT IN INDIA

While India has made remarkable progress in improving their investment climate, the country still faces many challenges in achieving its potential. As previously stated, the country's economic growth may be slowing and many Indians still live in poverty.[232] As Mark Baird, lead author of the *World Bank*

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227. Thornhill, *supra* note 204. A study completed by the Asian Development Bank Institute (ADBI) suggests that the authoritarian methods used by most east Asian governments were part of the reason for east Asia's economic miracles between the 1960s and 1980s. *Id.* The current Chinese government has resorted to similar policies in developing its economy, and many feel that a more democratic approach would have prevented China from acceding into the World Trade Organization. *Id.* While it is not suggested that India abandon its democratic philosophy, indeed democracy is seen as one of the country's greatest achievements by many, it is suggested that India be more flexible and broaden its economic freedoms. Decisions can be made much more quickly in China than in India because there is no need to negotiate or consult. This, along with the competitive populism of Indian states and political parties, hinders an effective national economic policy. *Id.*

228. *Id.*

229. WEI, *supra* note 135, at 17.

230. *Id.*

231. Thornhill, *supra* note 204. Also, many Indian economists suggest that India should not follow any of the models that China uses. *Id.* They argue that the overstated economic growth rate, the unacceptable and coercive treatment of minority groups, and its unsustainable political system will ultimately result in its economy crashing. The economists further suggest that when the economy does crater, China will be forced to open its political system and follow India's democratic path. *Id.*

232. Press Release, The World Bank Group, India has Made Impressive Progress, But Faces Major Challenges to Sustain the Trend, says World Bank Development Policy Review (July 19, 2003), *at* http://www.worldbank.org.in/WBSITE/EXTERNAL/COUNTRIES/SOUTHASIAEXT/INDIAEXTN/0,,contentMDK:20120511~menuPK:295603~pagePK:141137

Development Policy Review, said:

> At current trends, India's rate of progress is insufficient to meet its own Tenth Plan targets as well as the international community's Millennium Development Goals. To achieve its planned growth target of 8%, India will need to impart a fresh impetus to reform. Fiscal adjustment, along with other reforms to improve the investment climate, will be essential to accelerate growth. This will be good for the poor, who also need better access to quality services. These challenges are especially great in the poorer states, which have lagged behind progress at the national level.[233]

One of the main problems lies in the country's political governance, or lack thereof. Therefore, the best way India can increase the level of foreign investment would be to improve the quality of such investment throughout the country.[234] As major source countries are deterred from investing in corrupt and burdensome countries such as India, many opportunities for attracting FDI are lost. In fact, high corruption and burdensome regulations are generally seen as discouraging far more foreign investment than generous tax incentives and other benefits attract.[235] For example, it is estimated that if India reduced its corruption rating down to that of Singapore, it could achieve a 348% increase in foreign investment.[236] As stated before, the regulatory and administrative burden on firms in India is also a major impediment to growth and investment. Many countries regulate for legitimate and important governmental purposes,

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~piPK:141127~theSitePK:295584,00.html (last visited Mar. 23, 2005). India's annual economic growth fell from and average of 6.7% between 1992-93 and 1996-97 to 5.5% between 1997-98 and 2001-02, and further to 4.4% in 2002-03. *Id.*

233. *Id.*

234. CENT. INTELLIGENCE AGENCY, THE WORLD FACTBOOK: INDIA, *available at* http://www.cia.gov/cia/publications/factbook/geos/in.html (n.d.) (last modified Feb. 10, 2005). India's government takes the form of a federal republic, with twenty-eight states and seven union territories. *Id.* It is led by a president and vice president, elected every five years and a prime minister, elected by parliamentary members of the majority party following legislative elections. India's legal system is based on English common law; it has limited judicial review of legislative acts, and it accepts compulsory ICJ jurisdiction, with reservations. *Id.* While English is the most important language for national, political, and commercial communication, Hindi is the national language and primary tongue of thirty percent of the people. There are fourteen other official languages spoken in India: Bengali, Telugu, Marathi, Tamil, Urdu, Gujarati, Malayalam, Kannada, Oriya, Punjabi, Assamese, Kashmiri, Sindhi, and Sanskrit; Hindustani is a popular variant of Hindi/Urdu spoken widely throughout northern India but is not an official language. *Id.*

235. WEI, *supra* note 135, at 3.

236. *Id.* The corruption measure used was conducted by the World Economic Forum in 1996 for its Global Competitiveness Report of 1997. *Id.* at 3. It is a perception index based on a survey of 2,827 firms in fifty-eight countries. Singapore has a corruption rating of 1.6 on a scale of 1 to 7, while India has a rating of 5.1. *Id.*

"but in India the issues are more the extent and nature of regulation, its effectiveness and transparency, and the opportunities for harassment and corruption it provides."[237]

Another priority identified in improving investment is reforming the labor market. Restrictions on hiring and firing workers have been considered one of the greatest challenges to doing business in India.[238] By repealing legislation that prohibits lay-offs in medium and large firms, and changing the regulations that place constraints on the hiring of contract laborers, India could improve industrial performance and attract more private investment.[239] In addition to reforming the labor market, India should focus on improving the literacy rate. While they have made substantial progress over the last decade, especially with the female population, India still lags behind other Asian countries in education and health indicators.[240] As discussed throughout this paper, India has a large population of highly-skilled technical workers. However, that is counterbalanced by a very large uneducated, poorer population. "A successful, self-sustaining development process can be based only on the achievements of the individuals who comprise Indian society in all its dimensions."[241] By better educating their poor, India empowers them to participate in the growth of their economy, which in turn can increase productivity.[242]

India should also address their high real interest rates, which are also cited as an impediment to business performance and investing in the country. Further, credit has been expensive and time-consuming, if not impossible, to access, which restricts the development of companies.[243] The interest cost to Indian companies is about 5.5% of sales, compared to about four percent in most other Asian countries.[244] While there has been a recent decline in interest

237. *See generally* Stern, *supra* note 14. The World Bank has identified several other priorities that can be generally addressed to improve business performance, competitiveness, growth and prosperity in any country. *Id.* The first priority is industrial deregulation. This includes eliminating preferences and investment ceilings for small scale companies that result in these companies not being able to grow and compete in global markets. This also entails further easing constraints on foreign investment, such as increasing the equity percentages and the number of industries available for automatic approval. Further, opening the economy will allow firms and consumers to take advantage of increased integration into the global economy, and allow the country to maintain a stable macroeconomic environment. To maintain this stability, central and state governments need to raise revenues to control the accumulating fiscal and quasi-fiscal pressures. The regulatory procedures should be streamlined to provide clarity and transparency for investors. Finally, the deregulation includes revamping the bankruptcy legislation. *Id.*

238. *Id.* The labor legislation is designed to protect the organized work force, but this sector accounts for only seven percent of the total workforce.

239. *See id.* at 11.

240. *Id.* at 14. China, Indonesia, and Sri Lanka all have higher literacy rates than India. *Id.*

241. Stern Abstract, *supra* note 145.

242. Stern, *supra* note 14, at 14.

243. Carter, *supra* note 27.

244. Thornhill, *supra* note 204. These higher interest rates are a result of the country's high fiscal deficits and the high interest rates that India sets on savings accounts. *Id.*

rates, so far this has only benefited large, creditworthy borrowers and continues to evade the majority of companies.[245] It has been suggested that banks should make efforts to introduce new technologies and train branch managers to provide loans to commercially promising debtors.[246]

India also needs to improve its infrastructure, such as improving its power supply, telecommunications, transport, and water supply in additional areas other than special economic zones.[247] Power supply is considered one of the strongest bottlenecks to investment and growth in India, and it is critical for this sector to be reformed for investment to grow.[248] In fact, due to the steep costs and unreliability of power supply, about 70% of companies have been forced to buy their own generators.[249] The states will need to take action for this reform, rather than the central government, because they are the main providers of infrastructure in India.[250] As the focus of reform has been increasingly shifted away from the central government in this area, the states should try to create an environment that facilitates private investment to replace the scarce public capital. "While some progress has been made, India's demands for infrastructure services are still not being met. If the private sector is to play a big role in meeting India's infrastructure demands, then Indian needs sectoral policies and a regulatory framework that are conducive to private investment."[251] Also recommended is boosting agricultural and rural development. The agricultural sector is in dire need of reform, as it is critical to rural poverty reduction, in the areas of foodgrain policy, subsidies, domestic trade, and land access. According to Michael Carter, the World Bank's Country Director for India:

> India has undoubtedly done well in the last two decades, but with one-third of the world's poor and a billion people, it needs rapid growth and job creation to reduce poverty further and sustain the recent income increases. In the absence of comprehensive reform, growth will at best be moderate. India

245. Carter, *supra* note 27.

246. *Id.*

247. Stern, *supra* note 14, at 12. *See generally* Thornhill, *supra* note 204. India's transport services deter many investors because their high cost and inefficiency hinders domestic manufacturers. China's distribution and port system is much more efficient than India's, and results in Chinese manufacturers paying thirty-seven percent less than Indian manufacturers pay for shipping goods to the United States. *Id.*

248. Stern, *supra* note 14, at 12.

249. Thornhill, *supra* note 204.

250. Stern, *supra* note 14, at 12.

251. World Bank Group, *Needed: Private Investment in India's Infrastructure Creating the Right Environment for Investors*, *at* http://wbln1018.worldbank.org/sar/sa.nsf/0/927b3a7c48d9f4e18525686b0056d7a0?OpenDocument (n.d.) (last visited Mar. 23, 2005) (quoting Edwin Lim's address at the Conference on Distribution Reform (Oct. 12-13, 2001)).

> is a country with huge potential, and a new round of reform could accelerate growth to [eight] percent by the end of the Tenth Plan.[252]

It has also been suggested that one reason India has not achieved its potential, particularly in comparison to China, is because it lacks national ambition.[253] This could be a result of post-independence India attaching such an importance to economic self-reliance, as well as the country consciously advocating a Hindu versus Western view of economic success.[254] Some allege that there is a conservative attitude running throughout the leadership of the country, as many government representatives believe that India can achieve only a five percent rate of growth, while most economists suggest that it has the potential to grow at a ten percent rate.[255] Many Indians are frustrated with the amount of time the reform policy is taking. They feel that when politicians talk about the need for a carefully orchestrated reform process, they are making excuses for doing nothing. For India to achieve its realistic rate of growth, the government needs to develop policies which accurately reflect its potential and take action on those policies. Until then, the sleeping giant will continue to exist in a somewhat somnolent state!

252. WORLD BANK, NEW REPORT SUGGESTS HOW GOVERNMENTS AND CITIZENS MIGHT DO BETTER, *in* NEWS AND VIEWS QUARTERLY, Oct. 3, 2003, http://siteresources.worldbank.org/INTINDIA/Newsletters/20192927/OctNews.pdf (last visited Mar. 23, 2005).

253. Thornhill, *supra* note 204. This is the view of Tarun Das, the director-general of the Confederation of Indian Industry. *Id.*

254. *Id.*

255. *Id.*

LIBERALIZING TRADE IN LEGAL SERVICES: THE GATS, THE ACCOUNTANCY DISCIPLINES, AND THE LANGUAGE OF CORE VALUES

Ryan W. Hopkins*

I. INTRODUCTION

The practice of law has become big business.[1] The growth in law firm size and revenue has resulted, at least in part, from the increasingly global demands of clients.[2] As a result, more and more lawyers are traveling abroad to provide legal services.[3] Although few of these lawyers would probably consider themselves engaged in international trade, even when traveling abroad to counsel clients, the "international trade in legal services" has become an important and growing sector of many national economies.[4] For example, in 1986 cross-border legal services exports from the United States amounted to $97 million, while imports totaled $40 million. By 2001, cross-border exports

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* L.L.M., Newcastle Law School, University of Newcastle-upon-Tyne; J.D., University of Pittsburgh School of Law. The author would like to thank Professor Ronald A. Brand of the University of Pittsburgh School of Law for his continued encouragement and for his valuable comments on a prior draft. Some portions of this Article also appear in Ryan W. Hopkins, Comment, *Will the General Agreement on Trade in Services Necessitate Federal Involvement in Lawyer Regulation? Some Constitutional Implications of Regulating the Global Lawyer*, 66 U. PITT. L. REV. (forthcoming Spring 2005). The author gratefully acknowledges the permission granted by the University of Pittsburgh Law Review for use of this material.

1. Randall S. Thomas et al., *Megafirms*, 80 N.C. L. REV. 115, 116 (2001). "Big, bigger, biggest. Corporate law firms have exploded in size in the last two decades. So have accounting firms and investment banks. Many are now mammoth entities with thousands of employees, billions in revenues, and offices throughout the world." *Id. See also* U.S. INT'L TRADE COMM'N, RECENT TRENDS IN U.S. SERVICES TRADE: 2003 ANNUAL REPORT 10-6 (2003) [hereinafter RECENT TRENDS] (noting that the largest law firm in the United States, Skadden, Arps, Slate, Meagher & Flom, employed 1,800 lawyers and earned $1.2 billion in revenue in 2001).

2. Thomas et al., *supra* note 1, at 127. "Over the past thirty years, clients have shifted toward asking firms to provide them with more and more services on a broader and broader geographic basis. For example, globalization has led many clients to ask firms to handle increasingly complex transactions across international borders." *Id.*

3. *See* World Trade Organization [hereinafter WTO] Council for Trade in Services, *Legal Services: Background Note by the Secretariat*, S/C/W/43 at ¶ 25 (July 6, 1998) [hereinafter *Legal Services Background Note*] (quoting an OECD study that found that by 1995, over 300,000 of the world's lawyers traveled abroad to provide legal services at least occasionally).

4. *Id.* ¶ 20 (noting that by "the early 1990s the output of legal services represented 14% of all professional services and 1.1% of the economy in a 'representative' industrialised country").

of legal services in the United States reached $3.1 billion and imports hit $755 million, yielding a $2.4 billion trade surplus.[5]

Despite these developments, many countries, including the United States, have failed to account for this "cross-border" practice in the regulation of their legal professions.[6] As a result, significant barriers to cross-border practice remain.[7] In order to ensure that these barriers advance legitimate regulatory interests and do not unduly burden the cross-border provision of legal services, forty-eight countries have made the cross-border elements of their legal services sectors subject to the provisions of an international trade agreement called the General Agreement on Trade in Services (GATS).[8]

The GATS is the first multilateral trade agreement devoted to the progressive liberalization of the laws and regulations that govern the cross-border provision of services.[9] The GATS, which is administered by the World Trade Organization (WTO),[10] governs a wide array of services, from banking to tourism, and even accounting and legal services.[11] Anytime a service or services provider crosses a national border, the provisions of the GATS might be implicated. The GATS only *might* be implicated in such cross-border circumstances because when it was signed in 1995, much of how the GATS will govern trade in services, including legal services, was left for future negotiation.

These GATS negotiations are currently ongoing. The importance of these negotiations for American lawyers should not be underestimated. The GATS is important even for those practitioners engaged exclusively in domestic practice because the GATS may eventually influence how lawyers are governed in the United States. In the give-and-take of the legal services negotiations,

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5. RECENT TRENDS, *supra* note 1, at 10-1.

6. *See* Laurel S. Terry, *A Case Study of the Hybrid Model for Facilitating Cross-Border Legal Practice: The Agreement Between the American Bar Association and the Brussels Bars*, 21 FORDHAM INT'L L.J. 1382, 1384 (1998) ("[T]he *development* of cross-border practice throughout the world has vastly outpaced the *theory* of whether and how such practice should be regulated.") (italics in original); *see also* Ronald A. Brand, *Uni-State Lawyers and Multinational Practice: Dealing with International, Transnational, and Foreign Law*, 34 VAND. J. TRANSNAT'L L. 1135, 1137 (2001) (noting that "[w]hile the practice of law has moved from being local to national to international in scope, the regulation of the profession in the United States remains largely localized").

7. *See Legal Services Background Note*, *supra* note 3, ¶¶ 30-56 (noting barriers to cross-border practice including, inter alia, nationality, experience, and residency requirements).

8. General Agreement on Trade in Services [hereinafter GATS], Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization [hereinafter WTO Agreement], Annex 1B, LEGAL INSTRUMENTS – RESULTS OF THE URUGUAY ROUND vol. 31, 33 I.L.M. 1125, 1168 (1994), *available at* http://www.wto.org/english/docs_e/legal_e/26-gats.pdf (last visited Apr. 6, 2005).

9. WTO SECRETARIAT, GUIDE TO THE URUGUAY ROUND AGREEMENTS 161 (1999) [hereinafter GUIDE TO THE URUGUAY ROUND AGREEMENTS].

10. *See* WTO Agreement, *supra* note 8.

11. *See* GATT Secretariat, *Services Sectoral Classification List*, MTN.GNS/W/120 (July 10, 1991) (listing the services sectors covered by the GATS).

U.S. trade negotiators may be willing to grant foreign lawyers greater rights of practice than those enjoyed by domestic practitioners. This, in turn, could lead to calls from the American Bar to grant domestic lawyers interstate practice rights within the United States or even the right to participate in multidisciplinary partnerships (MDPs).[12] Put another way, there is a chance that U.S. trade negotiators might set in motion a chain of events that could affect the way that law is practiced in this country; and they may do so without the considered input of the profession itself.[13] Despite the profound impact that the GATS may have on U.S. lawyer regulations, the American Bar Association (ABA) has neither taken a public position on the current GATS negotiations, nor attempted to educate its members about the potential implications of the negotiations, as have other national bar associations.[14] This is unfortunate not

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12. The term "multidisciplinary partnerships" (MDPs) refers to partnerships between lawyers and nonlawyers, often accountants. For information regarding ethical rules that currently prohibit such partnerships in the United States, see MODEL RULES OF PROF'L CONDUCT R. 5.4 (2003) (providing that "[a] lawyer or law firm shall not share legal fees with a nonlawyer," and detailing a few narrow exceptions). However, this prohibition does not exist in all countries, nor even are regulations consistent in different jurisdictions within the same country. *See, e.g.*, Steven Mark, *Harmonization or Homogenization? The Globalization of Law and Legal Ethics – An Australian Viewpoint*, 34 VAND. J. TRANSNAT'L L. 1173, 1195 (2001) (noting that New South Wales is the only Australian jurisdiction to permit MDPs). For a more comprehensive treatment of the issues surrounding MDPs, see Laurel S. Terry, *A Primer on MDPs: Should the "No" Rule Become a New Rule?*, 72 TEMPLE L. REV. 869 (1999).

13. *See* Laurel S. Terry, *GATS' Applicability to Transnational Lawyering and its Potential Impact on U.S. State Regulation of Lawyers*, 34 VAND. J. TRANSNAT'L L. 989, 1085 (2001). Professor Terry's article is required reading for those interested in exploring the potential impact of the GATS on legal services. For those who are new to the GATS, see INT'L BAR ASS'N, GATS: A HANDBOOK FOR INTERNATIONAL BAR ASSOCIATION MEMBER BARS (2002), *available at* http://www.ibanet.org/images/downloads/gats.pdf [hereinafter IBA GATS HANDBOOK] (providing an excellent introduction to the basic workings of the GATS and comprehensive explanations of the sometimes unfamiliar terms often employed in trade agreements).

14. *See generally* Laurel S. Terry, *A Challenge to the ABA and the U.S. Legal Profession to Monitor the GATS 2000 Negotiations: Why You Should Care*, Symposium Issue of PROF. LAW. (2001) [Terry, *Why You Should Care*]. Although the ABA Center for Professional Responsibility now has a website devoted to the GATS, in the view of this author, the site, which links to various GATS documents, fails to explain the issues surrounding the GATS negotiations in a cogent manner. Only through reading the primary GATS documents located on the website can one gain an appreciation of the issues at stake in the negotiations. Unfortunately, this would require an expenditure of time that few practitioners can spare. *See* Am. Bar Ass'n Ctr. for Prof'l Responsibility, *Materials About the GATS and Other International Agreements*, *at* http://www.abanet.org/cpr/gats/gats_home.html (n.d.) (last visited Apr. 14, 2005). The website also reports that "in 2003, ABA President A.P. Carlton appointed an ABA GATS Task Force. This Task Force is responsible for coordinating ABA efforts regarding the GATS," although little information is provided on the work of the Task Force to date. While these ABA developments may prove to be positive, this author remains skeptical that they will contribute to the enlightenment of the American bar. *See generally* Am. Bar Ass'n, *American. Bar Association*, *at* http://www.abanet.org (n.d.) (last visited Apr. 14, 2005). An exception to the general lack of enthusiasm for explaining the impact the GATS may have on American lawyers is the writing of Professor Laurel Terry. Professor Terry is "a liaison from

only for American lawyers, but, as will be highlighted below, the solutions to multijurisdictional practice issues that the ABA has proposed in the domestic context might provide a point of compromise in the GATS negotiations.[15]

Of the bar associations that are participating in the discussion of how the GATS rules will come to regulate the legal profession, many have been less than enthusiastic about some of the proposals put forward in the negotiations. This is understandable given that comprehensive GATS rules may impinge on the ability of national authorities to regulate all aspects of the legal profession within their respective jurisdictions. One of the principal criticisms of the GATS proposals from national bar groups and other legal professionals is that the proposals violate one or more of the "core values" of the legal profession.

It is typically the case that when new regulatory structures are proposed in response to the ever-changing realities of legal practice, the charge is advanced that the new rules violate one or more of these core values of the legal profession.[16] Reliance on core values can be seen as a strategy of sorts to preclude debate on certain topics; to place certain principles beyond the realm of negotiation. It is strategy, in other words, for protecting what the profession holds most dear. It must also be recognized, however, that core values arguments are subject to abuse. They may be deployed to squelch debate even where legitimate controversy exists and are a convenient method of protecting the regulatory prerogatives of entrenched interests.[17]

This Article proposes to evaluate the impact that core values arguments are likely to exert upon the prospects for a successful conclusion of the GATS legal services negotiations. In particular, this work seeks to highlight the potential for obstruction that reliance on core values presents. Part II of this Article begins by explaining the ways in which the GATS affects trade in legal services, providing the necessary background for an understanding of the negotiations currently underway to liberalize trade in legal services. These

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the ABA Center for Professional Responsibility to the ABA GATS Task Force," Laurel S. Terry, *Current Developments Regarding the GATS and Legal Services: The Cancun Ministerial GATS Negotiations*, B. EXAMINER 38 (Feb. 2004) [hereinafter Terry, *Cancun Ministerial*], and has written an excellent series of articles on the GATS legal services negotiations. These articles are available at http://www.abanet.org/cpr/gats/articles.html (last visited Apr. 14, 2005).

15. *See infra* Part VI.

16. In the United States, such charges were most forcefully promoted in the debate within the ABA over whether to amend the Model Rules of Professional Conduct to permit lawyers to participate in multidisciplinary partnerships (MDPs). Dale R. Harris, Remarks at the American Bar Association House of Delegates Debate on Multidisciplinary Partnerships (July 11, 2000), *available at* http://www.abanet.org/cpr/mdp_hod_transc.html (noting support for multidisciplinary partnerships "provided that they be done in a way to protect the public interest and preserve our core values") (last visited Apr. 6, 2005). In reaction to the MDP debate, the ABA adopted a resolution affirming the core values of the legal profession. AM. BAR ASS'N HOUSE OF DELEGATES RECOMMENDATION (July 2000), *available at* http://www.abanet.org/cpr/mdprecom10f.html (last visited Apr. 6, 2005) [hereinafter ABA CORE VALUES RECOMMENDATION].

17. As Sydney Cone has put it, "[n]ot infrequently, the local legal profession, in the name of protecting 'the public,' has done a mighty fine job of protecting itself." SYDNEY M. CONE III, INTERNATIONAL TRADE IN LEGAL SERVICES § 3:1 (1996).

negotiations are the focus of Part III. Part IV enumerates the key provisions of the prime negotiating document, the *Disciplines on Domestic Regulation in the Accountancy Sector*,[18] and explains the more forceful criticisms of those provisions offered by some national bar associations. Part V is devoted to evaluating the bar associations' critiques and to gauging the consequences of the core values arguments they advance. Finally, although the ABA has not expressed its view of the core values debate, Part VI considers how some "core values" arguments might be resolved under the ABA *Model Rules of Professional Conduct* and how recent developments within the ABA could provide a basis for compromise in the current GATS negotiations.

In the end, this Article concludes that the core values arguments promoted by some bar associations are most accurately seen as efforts by national authorities to maintain their traditional regulatory monopolies over legal professionals, and thus have the potential to foreclose the resolution of issues that are crucial to a successful conclusion of the legal services negotiations.

II. THE GENERAL AGREEMENT ON TRADE IN SERVICES: HOW THE GATS AFFECTS TRADE IN LEGAL SERVICES

The negotiation and signing of the GATS during the Uruguay Round trade negotiations signaled the large and growing importance of "trade in services" to the global economy.[19] Moreover, the centrality of the GATS in the international regulation of services regimes have led some to call the Agreement the most important development in the multilateral trading system since the General Agreement on Tariffs and Trade (GATT) became effective in 1948.[20] Nevertheless, these are still early days for the GATS and much of how its rules will govern trade in services has been left for future negotiations.[21] In

18. WTO Council for Trade in Services, *Disciplines on Domestic Regulation in the Accountancy Sector*, S/L/64 (Dec. 17, 1998) [hereinafter *Accountancy Disciplines*].

19. *See* WTO, INTERNATIONAL TRADE STATISTICS 2003 (2003), http://www.wto.org/english/res_e/statis_e/its2003_e/its2003_e.pdf (last visited Apr. 6, 2005). In 2002, the value of global services exports totaled $1,570 billion U.S.D., or nearly a quarter of all exports worldwide. *Id.* at 2. In order to get an idea of the magnitude of the growth of the services trade in recent years consider that exports of services rose six percent over the year 2001-2002, an increase that represents the same amount of growth over the ten year period 1990-2000. *Id.*

20. GUIDE TO THE URUGUAY ROUND AGREEMENTS, *supra* note 9, at 161.

21. *Id.* "The GATS rules are not quite complete, and are largely untested. This process of filling the gaps will require several more years of negotiations, and experience will no doubt show a need to improve some of the existing rules." *Id.* Professor Laurel Terry has described the GATS as an example of a "legislative-delegation model" of regulating the cross-border provision of services because it leaves the task of developing more detailed obligations to various WTO institutions. Terry, *supra* note 6, at 1392 (discussing the operation of such a model in the development of rules to govern the cross-border provision of legal services).

the meantime, we are left with the Agreement itself and the ways in which it currently constrains WTO members from erecting protectionist barriers to services markets.

The GATS obligations and derogations of WTO Member States are found in the following documents: (1) the "framework agreement"[22] made up of the twenty-nine articles and eight annexes[23] found in Annex 1B of the WTO Agreement;[24] (2) the Schedules of Specific Commitments[25] reflecting obligations assumed by WTO Member States in specific services sectors at the conclusion of the Uruguay Round negotiations;[26] and (3) lists of authorized exemptions from most-favored-nation (MFN) treatment filed by WTO Members with respect to certain services sectors.[27] Each of these sources will be considered in turn.

A. The Framework Agreement

Part I ("Scope and Definition") delineates the reach[28] of the Agreement and provides a rather broad definition of trade in services.[29] This definition includes the supply of services in any one of four different "modes." These

22. *See* CONE, *supra* note 17, § 2:15 (using the term "framework agreement" to describe the GATS itself).

23. GATS, *supra* note 8. Only one of these annexes, Annex on Article II Exemptions, is relevant to legal services. *See infra* notes 54-57 and accompanying text. The other annexes include: Annex on Movement of Natural Persons Supplying Services under the Agreement; Annex on Air Transport Services; Annex on Financial Services; Second Annex on Financial Services; Annex on Maritime Transport Services; Annex on Telecommunications; and Annex on Basic Telecommunications. *See* GATS, *supra* note 8. The Annex on Movement of Natural Persons Supplying Services under the Agreement would seem to apply to legal services. However, on March 1, 1995, the Council for Trade in Services effectively nullified the import of this Annex by adopting a conclusion of the Sub-Committee on Services that "what appears in the schedules of participants is sufficiently clear and . . . that there was no need for further multilateral work on this issue." WTO Council for Trade in Services, *Issues Relating to the Scope of the GATS: Report by the Chairman of the Sub-Committee on Services*, S/C/1 (Feb. 15, 1995); WTO Council for Trade in Services, *Report of the Meeting Held 1 March 1995: Note by the Secretariat*, S/C/M/1 (Mar. 22, 1995).

24. GATS, *supra* note 8.

25. WTO, *Guide to Reading GATS Schedules of Specific Commitments and the Lists of Article II (MFN) Exemptions*, *at* http://www.wto.org/english/tratop_e/serv_e/guide1_e.htm (last visited Feb. 21, 2005) [hereinafter Guide to Reading GATS Schedules]. "A specific commitment in a services schedule is an undertaking to provide market access and national treatment for the service activity in question on the terms and conditions specified in the schedule." *Id.* For an excellent explanation of how GATS schedules developed and their foundation in the WTO request-offer system, *see* Terry, *supra* note 13, at 1004.

26. *See infra* notes 47-53 and accompanying text.

27. *See infra* notes 54-57 and accompanying text.

28. GATS, *supra* note 8, at art. I(1) ("This Agreement applies to measures by Members affecting trade in services.").

29. *Id.* at art. I(3)(b) ("'services' includes *any service* in *any sector* except services supplied in the exercise of governmental authority") (emphasis added).

include: (1) the "cross-border" supply of services;[30] (2) the "consumption abroad" of services;[31] (3) the "commercial presence" of foreign services suppliers;[32] and (4) the temporary "presence of natural persons."[33] This multifaceted definition of "services" may, at first blush, seem rather complicated, but the four modes of supply form the categories in which WTO Member States schedule concessions.[34] The categorization of services in this way also permits meaningful comparisons of the varying restrictions that Member States may impose in particular services sectors.[35]

GATS obligations imposed on Member States come in two basic varieties, unconditional and conditional. Part II (entitled "General Obligations and Disciplines") contains the unconditional obligations; those undertakings that apply to all WTO Members regardless of whether they have scheduled commitments in specific services sectors.[36] The most important of these obligations is the duty to provide most-favored nation (MFN) treatment to services and service suppliers of other Members,[37] an undertaking already well

30. *Id.* at art. I(2)(a) ("from the territory of one Member into the territory of any other Member"). This mode of supply is implicated whenever the service itself crosses a border. *See* Terry, *supra* note 13, at 1008 ("Mode 1 is involved whenever foreign lawyers create a legal product or advice, which is then sent from outside the U.S. border to clients inside the United States.").

31. *Id.* at art. I(2)(b) ("in the territory of one Member to the service consumer of any other Member"). This provision speaks to the ability of a consumer from one Member State country to go to another Member State country and to buy services while there. *See* Terry, *supra* note 13, at 1008 ("Mode 2, or Consumption abroad, involves the ability of U.S. citizens to purchase abroad the services of foreign lawyers.").

32. *Id.* at art. I(2)(c) ("by a service supplier of one Member, through commercial presence in the territory of any other Member"). This is also commonly referred to as the "right of establishment." Terry, *supra* note 13, at 1008 ("Mode 3, or Commercial presence, involves the ability of foreign lawyers to set up a permanent presence in the United States, such as a branch office.").

33. *Id.* at art. I(2)(d) ("by a service supplier of one Member, through the presence of natural persons of a Member in the territory of any other Member"). *See* Terry, *supra* note 13, at 1008 ("Mode 4, or the presence of Natural Persons, addresses the situation in which the foreign lawyers themselves enter the United States in order to offer legal services.").

34. *See infra* notes 47-53 and accompanying text.

35. *Guide to Reading GATS Schedules*, *supra* note 25 ("The national schedules all conform to a standard format which is intended to facilitate comparative analysis.").

36. GUIDE TO THE URUGUAY ROUND AGREEMENTS, *supra* note 9, at 165 ("Part II sets out 'general obligations and disciplines.' These are basic rules that apply to all members and, for the most part, to all services.").

37. GATS, *supra* note 8, at art. II(1). "With respect to any measure covered by this Agreement, each Member shall accord immediately and unconditionally to services and service suppliers of any other Member treatment no less favorable than that it accords to like services and service suppliers of any other country." *Id.*

familiar to students of the GATT. There are, however, other unconditional GATS commitments unknown to the GATT, including measures related to transparency,[38] recognition of academic and professional qualifications,[39] and provisions regulating internal licensing procedures, or domestic regulations.[40]

The conditional obligations of the GATS, which only apply to services sectors in which a member has undertaken specific commitments, [41] are two-fold and are found in Part III ("Specific Commitments"). The first of these obligations is the prohibition on market access restrictions found in Article XVI.[42] Specifically, this provision prohibits a Member from, for instance, placing quotas on the number of foreign services suppliers,[43] limiting the total value of foreign services transactions,[44] or restricting the number of foreign persons that may be employed in a particular services sector.[45]

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38. *See Id.* at art. III(1).

> Each Member shall publish promptly and, except in emergency situations, at the latest by the time of their entry into force, all relevant measures of general application which pertain to or affect the operation of this Agreement. International agreements pertaining to or affecting trade in services to which a Member is a signatory shall also be published.

Id.

39. *See Id.* at art. VII(1).

> For the purposes of the fulfillment, in whole or in part, of its standards or criteria for the authorization, licensing or certification of services suppliers . . . a Member may recognize the education or experience obtained, requirements met, or licenses or certifications granted in a particular country. Such recognition, which may be achieved through harmonization or otherwise, may be based upon an agreement with the country concerned or may be accorded autonomously.

Id.

40. The GATS domestic regulation provisions are comprehensively addressed *infra* at Part III.B.1.

41. GUIDE TO THE URUGUAY ROUND AGREEMENTS, *supra* note 9, at 171.

42. GATS, *supra* note 8, at art. XVI(1). "With respect to market access through the modes of supply identified in Article I, each Member shall accord services and service suppliers of any other Member treatment no less favorable than that provided for under the terms, limitations and conditions agreed and specified in its Schedule." *Id.*

43. *Id.* at art. XVI(2)(a).

> 2. In sectors where market-access commitments are undertaken, the measures which a Member shall not maintain or adopt either on the basis of a regional subdivision or on the basis of its entire territory, unless otherwise specified in its Schedule, are defined as:
>
> (a) limitations on the number of service suppliers whether in the form of numerical quotas, monopolies, exclusive service suppliers or the requirements of an economic needs test;

Id.

44. *Id.* at art. XVI(2)(b) ("limitations on the total value of service transactions or assets in the form of numerical quotas or the requirement of an economic needs test").

45. *Id.* at art. XVI(2)(d) ("limitations on the total number of natural persons that may be employed in a particular service sector or that a service supplier may employ and who are necessary for, and directly related to, the supply of a specific service in the form of numerical quotas or the requirement of an economic needs test").

The second undertaking placed upon scheduled services sectors is found in the national treatment, or non-discrimination, obligation of Article XVII.[46] Like the undertaking to provide MFN treatment, the GATS national treatment provision enforces obligations similar to analogous GATT provisions. So while it seems that the GATS is well on its way to injecting a measure of discipline into services regulations with tried and true liberalizing concepts, these undertakings are conditioned by the two other sources of GATS law: the Members' Schedules of Specific Commitments and the lists of Article II exemptions, both of which are addressed in the next section.

B. Derogating from the GATS: Schedules of Specific Commitments and Article II Exemptions

Although "scheduled" services sectors are subject to the more rigorous market access and national treatment obligations of the GATS, Member States were free to choose which sectors would be submitted to this enhanced discipline.[47] During the initial Uruguay Round negotiations, forty-eight Member States took the decision to submit their legal services sectors to the obligations inherent in Part III of the GATS.[48] Much of the sting of the market access and national treatment obligations was nonetheless removed by the content of Member States' schedules. Most of the Member States that included legal services on their Schedules of Specific Commitments did so by listing

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46. *Id.* at art. XVII.

> 1. In the sectors inscribed in its Schedule, and subject to any conditions and qualifications set out therein, each Member shall accord to services and service suppliers of any other Member, in respect of all measures affecting the supply of services, treatment no less favorable than that it accords to its own like services and service suppliers.
> 2. A Member may meet the requirement of paragraph 1 by according to services and service suppliers of any other Member, either formally identical treatment or formally different treatment to that it accords to its own like services and service suppliers.
> 3. Formally identical or formally different treatment shall be considered to be less favorable if it modifies the conditions of competition in favor of services or service suppliers of the Member compared to like services or service suppliers of any other Member.

Id.

47. However, because inclusion or exclusion of particular services sectors was the subject of intense negotiations, some Member States scheduled services sectors that they might otherwise have sought to protect in order to gain concessions in other sectors and under different agreements. *See, e.g.*, CONE, *supra* note 17, at § 2:6-7 (explaining how Japan was persuaded to rejoin the GATS legal services negotiations in response to intense pressure by the United States and the European Community).

48. GUIDE TO THE URUGUAY ROUND AGREEMENTS, *supra* note 9, at 199 (including twenty-five developed countries, nineteen developing countries, and four transition economies). For individual Member States' GATS Schedules, see WTO Services Database, *at* http://tsdb.wto.org/wto/WTOHomepublic.htm (n.d.) (last visited Feb. 1, 2005).

their current regulations.[49] The legal effect of listing current laws in a GATS schedule is to effectively exempt those laws from the market access and national treatment obligations.[50] A Member State may not, however, impose regulations in a scheduled sector that are more onerous than the current regulations listed in that Member's GATS schedule.[51] This means that although few restrictions on trade in legal services were rolled back during the Uruguay Round, future regulations adopted by scheduling Member States can be no more restrictive than current regulations.[52] That is why the GATS is sometimes said to impose "standstill" or "grandfathered" obligations on Member States.[53]

Another means by which Member States were given the opportunity during the Uruguay Round to mitigate their obligations arising under the GATS was to submit lists of sectoral exemptions from MFN treatment.[54] If a Member State placed a particular sector on its list, it was no longer obligated to provide MFN treatment in that sector.[55] Although the Article II exemptions lists must be examined in determining the extent of Member States' obligations, very few

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49. *See* Michael J. Chapman & Paul J. Tauber, *Liberalizing International Trade in Legal Services: A Proposal for an Annex on Legal Services under the General Agreement on Trade in Services*, 16 MICH. J. INT'L L. 941, 967 (1995) (analyzing the submitted legal services schedules of WTO Members and concluding that "in most cases, the commitments merely preserved existing regulatory measures").

50. *See* GUIDE TO THE URUGUAY ROUND AGREEMENTS, *supra* note 9, at 171 ("Service commitments resemble those in a GATT schedule at least in one very important respect: they are bindings which set out *the minimum, or worst permissible, treatment of the foreign service or its supplier*.") (emphasis added).

51. CONE, *supra* note 17, at § 2:32 ("Article XVII will prevent the adoption of any *additional* discriminatory measures that were not in effect on December 15, 1993, and not expressly covered by a Schedule of Specific Commitments or MFN list in a GATS offer in respect of legal services.").

52. Nevertheless, a Member State may have preserved its right to impose more restrictive regulations in the future by noting in its schedule that a particular sector or mode of supply is "unbound." For a detailed explanation of the terms used in scheduling commitments and the legal effect of those terms, see *Guide to Reading GATS Schedules*, *supra* note 25 ("All commitments in a schedule are bound unless otherwise specified. In such a case, where a Member wishes to remain free in a given sector or mode of supply to introduce or maintain measures inconsistent with market access or national treatment, the Member has entered in the appropriate space the term UNBOUND.").

53. *See, e.g.*, CONE, *supra* note 17, at § 2:31-32 (using the term "standstill" to describe scheduled obligations); Terry, *supra* note 13, at 1005 (noting that the GATS "grandfathers in" existing sets of regulations).

54. GATS, *supra* note 8, at Annex on Article II Exemptions.

55. *Id.* ¶ 1 ("This Annex specifies the conditions under which a Member, at the entry into force of this Agreement, is exempted from its obligations under paragraph 1 of Article II.").

states included legal services on their respective Article II exemptions list.[56] Therefore, a fuller treatment of the issues surrounding these exemptions is beyond the scope of this Article.[57]

In summary, in order to determine a Member State's GATS undertakings in respect of legal services, or any other services sector, one must look to three sources of GATS obligations: (1) the unconditional commitments to which all WTO Members are subject, mostly found in Part II of the GATS framework agreement; (2) the commitments found in Member States' Schedules of Specific Commitments to which the market access and national treatment obligations of Part III apply; and (3) the MFN exemptions lists submitted during the Uruguay Round negotiations, which excuse Members from granting MFN treatment in specified services sectors.

As cumbersome as determining a Member State's GATS obligations is under this three-step procedure, it is only the starting point for investigating the true extent of how GATS may come to regulate legal services in the future. Given the incomplete nature of the GATS regime,[58] one must look to some of the negotiations that occurred soon after the GATS came into effect and to those that are currently ongoing in order to more fully comprehend how GATS obligations may constrain legal services regulators.[59] These negotiations are the focus of Part III.

III. DOMESTIC REGULATION AND THE WORKING PARTY ON PROFESSIONAL SERVICES: A BRIEF HISTORY OF THE POST-GATS NEGOTIATIONS

A. Progressive Liberalization and the Two-Track Negotiations

Article XIX of the GATS, entitled "Negotiation of Specific Commitments," provides for future liberalizing negotiations to begin no later than five years after the coming into force of the GATS.[60] In accord with this

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56. *See* CONE, *supra* note 17, at § 2:22 (listing GATS members that submitted MFN-exemption lists in legal services, including: Brunei Darussalam, China (which was still negotiating WTO membership at the time), Costa Rica, Cyprus, Dominican Republic, El Salvador, Guatemala, Honduras, Jamaica, Malta, Singapore, Turkey, and Venezuela).

57. For a discussion of the unsettled issues surrounding MFN exemptions, see Terry, *supra* note 13, at 1003-04.

58. *See supra* note 21 and accompanying text.

59. *See* Terry, *supra* note 13, at 1019 ("[O]ne must recognize that because GATS used a legislative-delegation model, one cannot fully understand the obligations imposed by the GATS until one examines the post-GATS developments.").

60. GATS, *supra* note 8, at art. XIX(1).

> In pursuance of the objectives of this Agreement, Members shall enter into successive rounds of negotiations, beginning not later than five years from the date of entry into force of the WTO Agreement and periodically thereafter, with a view to achieving a progressively higher level of liberalization. Such negotiations shall be directed to the reduction or elimination of the adverse effects on trade in services of measures as a means of providing effective market access. This process shall take place with a view to promoting the interests of all

mandate, on February 25, 2000, new services negotiations began.[61] These negotiations were often referred to as the "GATS 2000 negotiations"[62] or the "built-in agenda" negotiations.[63] On November 14, 2001, the WTO Ministerial Conference meeting in Doha, Qatar, adopted the Fourth Ministerial Declaration, which launched the current round of trade negotiations known as the Doha Development Agenda (DDA).[64] This "Doha Declaration" also endorsed the work that had been done in the GATS 2000 negotiations and subsumed its future work into the DDA negotiating framework.[65] These negotiations were scheduled to conclude no later than January 1, 2005,[66] and

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> participants on a mutually advantageous basis and to securing an overall balance of rights and obligations.

Id.

61. Press Release, WTO, Services Negotiations Formally Launched (Feb. 25, 2000), *at* http://www.wto.org/english/news_e/news00_e/servfe_e.htm (last visited Apr. 6, 2005).

62. *See, e.g.*, Director General Renato Ruggiero, Towards GATS 2000 – A European Strategy, Address to the Conference on Trade in Services, organized by the European Commission (June 2, 1998), *available at* http://www.wto.org/english/news_e/sprr_e/bruss1_e.htm (last visited Apr. 6, 2005).

63. *See, e.g.*, Terry, *supra* note 13, at 1050 n.193 (employing the term and explaining its meaning).

64. WTO Ministerial Conference, *Ministerial Declaration*, WT/MIN(01)/DEC/1 (Nov. 20, 2001), http://www.wto.org/english/thewto_e/minist_e/min01_e/mindecl_e.pdf (last visited Apr. 6, 2005).

65. *Id.* ¶ 15.

> The negotiations on trade in services shall be conducted with a view to promoting the economic growth of all trading partners and the development of developing and least-developed countries. We recognize the work already undertaken in the negotiations, initiated in January 2000 under Article XIX of the General Agreement on Trade in Services, and the large number of proposals submitted by Members on a wide range of sectors and several horizontal issues, as well as on movement of natural persons. We reaffirm the Guidelines and Procedures for the Negotiations adopted by the Council for Trade in Services on 28 March 2001 as the basis for continuing the negotiations, with a view to achieving the objectives of the General Agreement on Trade in Services, as stipulated in the Preamble, Article IV and Article XIX of that Agreement.

Id.

66. *Id.* ¶ 45 ("The negotiations to be pursued under the terms of this declaration shall be concluded not later than 1 January 2005."). The Doha negotiations, including the so-called "Track 1" GATS legal services negotiations, were temporarily abandoned in September 2003 at the Fifth WTO Ministerial Conference in Cancún, Mexico. For more information on the breakdown of the Cancún negotiations see Terry, *Cancun Ministerial*, *supra* note 14, at 38. The WTO Member States resumed the Track 1 negotiations and the rest of the Doha Work Programme pursuant to an August 1, 2004 decision of the WTO General Council. The decision did not set a revised deadline for conclusion of the services negotiations but did set a May 2005 deadline for the tabling of revised services offers. *See* WTO, *Doha Work Programme Decision Adopted by the General Council on 1 August 2004*, WT/L/579, at 3 & Annex C (Aug. 2, 2004). However, the "Track 2" or "disciplines" negotiations continued despite the collapse of the Track 1 negotiations at Cancún. Laurel S. Terry, *Lawyers, GATS, and the WTO Accountancy Disciplines: The History of the WTO's Consultation, the IBA GATS Forum and the September 2003 IBA Resolutions*, 22 PENN ST. INT'L L. REV. 695, 706 (2004) ("the WPDR continued its work on the Disciplines issues even when other Doha negotiations had collapsed following the September 2003 Ministerial Conference in Cancun, Mexico.").

are the kind of "request-offer" negotiations that have become familiar over the past fifty years within the GATT framework.[67] There is, however, another "track" of negotiations currently ongoing in Geneva that could more profoundly affect the way that GATS regulates trade in legal services.[68] These are the negotiations occurring in the Working Party on Domestic Regulation (WPDR), which is considering the feasibility of developing horizontal disciplines on domestic regulation.[69] Because of the importance of these "disciplines" negotiations to the future regulation of trade in legal services they will be the focus of the remainder of this section.

B. Article VI and the Accountancy Disciplines

In order to properly evaluate the proposals currently being advanced in the WPDR with respect to horizontal and sector-specific disciplines, it is necessary to become familiar with the GATS domestic regulation provisions and with post-GATS developments in the accountancy sector.

1. Article VI: Domestic Regulation

As used in the GATS, the term "domestic regulation" refers to any generally applicable measure that may have the potential to adversely affect the provision of trade in services for which a Member State has undertaken specific obligations.[70] Article VI of the GATS provides that these measures shall be administered in a "reasonable, objective and impartial manner."[71] More specifically, Article VI requires Member States to maintain judicial or administrative tribunals for review of decisions that affect trade in services.[72]

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67. *See id.* ¶ 15 ("Participants shall submit initial requests for specific commitments by 30 June 2002 and initial offers by 31 March 2003.").

68. *Cf.* Paul D. Paton, *Legal Services and the GATS: Norms as Barriers to Trade*, 9 NEW ENG. J. INT'L & COMP. L. 361, 405-06 (2003) (analyzing Member State DDA proposals on legal services and noting a "very limited ambition for meaningful liberalization of legal services").

69. IBA GATS HANDBOOK, *supra* note 13, at 3.

> Currently there are two different sets of events ongoing in Geneva of which member bars should be aware (and may want to participate). The first ongoing activity is the development of horizontal disciplines on domestic regulation. The second development is the new Doha Round of negotiations for further liberalization of trade in services. Although there is some overlap between these two 'tracks' or developments, they are different and Member Bars should be aware of both.

Id.

70. GATS, *supra* note 8, at art. VI(1) ("In sectors where specific commitments are undertaken, each Member shall ensure that all measures of general application affecting trade in services are administered in a reasonable, objective and impartial manner."). Note, however, that some provisions of Article VI, notably Article VI(2), *see infra* note 72, apply to all WTO Members whether or not they have scheduled services in a particular sector.

71. *Id.* at art. VI(1).

72. *Id.* at art VI(2).

The appropriate authorities are also obligated to promptly review any required applications for the supply of services within a Member State's jurisdiction.[73] These measures are likely to be very important for the regulation of trade in legal services because they address the kinds of requirements that are often used to restrict the practice of foreign legal practitioners, namely, licensing and qualification rules.[74]

In order to ensure that these domestic regulation measures are given their appropriate effect, Article VI also directs the Council for Trade in Services, or one of its subsidiaries, to develop more specific "disciplines" to govern the regulation of trade in services.[75] This provision has formed the basis of the

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(a) Each Member shall maintain or institute as soon as practicable judicial, arbitral or administrative tribunals or procedures which provide, at the request of an affected service supplier, for the prompt review of, and where justified, appropriate remedies for, administrative decisions affecting trade in services. Where such procedures are not independent of the agency entrusted with the administrative decision concerned, the Member shall ensure that the procedures in fact provide for an objective and impartial review.

(b) The provisions of subparagraph (a) shall not be construed to require a Member to institute such tribunals or procedures where this would be inconsistent with its constitutional structure or the nature of its legal system.

Id.

73. *Id.* at art. VI(3).

Where authorization is required for the supply of a service on which a specific commitment has been made, the competent authorities of a Member shall, within a reasonable period of time after the submission of an application considered complete under domestic laws and regulations, inform the applicant of the decision concerning the application. At the request of the applicant, the competent authorities of the Member shall provide, without undue delay, information concerning the status of the application.

Id.

74. Terry, *supra* note 13, at 1002 ("Domestic regulation is also potentially significant to legal services regulators because of its requirement that, for those including legal services on their Schedules, regulatory measures, such as admission, licensing, and discipline measures, be administered in a reasonable, objective, and impartial manner and that qualification requirements be not more burdensome than necessary to ensure the quality of the service."); *see also* Legal Services Background Note, *supra* note 3, ¶¶ 41, 47 (noting that "[q]ualification requirements often represent an insurmountable barrier to trade in legal services" and that "foreign legal consultants still face important regulatory barriers in particular with respect to licensing requirements").

75. GATS, *supra* note 8, at art. VI(4).

With a view to ensuring that measures relating to qualification requirements and procedures, technical standards and licensing requirements do not constitute unnecessary barriers to trade in services, the Council for Trade in Services shall, through appropriate bodies it may establish, develop any necessary disciplines. Such disciplines shall aim to ensure that such requirements are, *inter alia*:

(a) based on objective and transparent criteria, such as competence and the ability to supply the service;

(b) not more burdensome than necessary to ensure the quality of the service;

"disciplines" track of the current negotiations as well as the backdrop for much of the post-GATS progress towards liberalized markets in services.

2. The Working Party on Professional Services and the Accountancy Disciplines

In addition to the direction found in Article VI, the impetus to develop multilateral disciplines was provided by the Decision on Professional Services, adopted by the Ministerial Conference as part of the Final Act Agreements.[76] The Decision first directed the Council for Trade in Services to create a Working Party on Professional Services (WPPS) to oversee the development of the disciplines mandated by Article VI(4).[77] The Decision also directed the newly constituted WPPS to begin its work by elaborating disciplines for the accountancy sector.[78] As part of this mandate, the WPPS was given the further task of establishing guidelines for the recognition of qualifications.[79] The

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(c) in the case of licensing procedures, not in themselves a restriction on the supply of the service.

Id.

76. GATS, *supra* note 8.

77. *Id.* ¶ 1.

> The work programme foreseen in paragraph 4 of Article VI on Domestic Regulation should be put into effect immediately. To this end, a Working Party on Professional Services shall be established to examine and report, with recommendations, on the disciplines necessary to ensure that measures relating to the qualification requirements and procedures, technical standards and licensing requirements in the field of professional services do not constitute unnecessary barriers to trade.

Id.

78. *Id.* ¶ 2.

> As a matter of priority, the Working Party shall make recommendations for the elaboration of multilateral disciplines in the accountancy sector, so as to give operational effect to specific commitments. In making these recommendations, the Working Party shall concentrate on:
>
> (a) developing multilateral disciplines relating to market access so as to ensure that domestic regulatory requirements are (i) based on objective criteria, such as competence and the ability to supply the service; (ii) not more burdensome than necessary to ensure the quality of the service, thereby facilitating the effective liberalization of accountancy services;
>
> (b) the use of international standards and, in doing so, it shall encourage the cooperation with the relevant international organizations as defined under paragraph 5(b) of Article VI [referring to "international bodies whose membership is open to the relevant bodies of at least all Members of the WTO"], so as to give full effect to paragraph 5 of Article VII [relating to adoption of common international standards].

Id.

79. *Id.* ¶ 2 ("facilitating the effective application of paragraph 6 of Article VI of the Agreement [relating to the verification of professional competence] by establishing guidelines for the recognition of qualifications"). The Council for Trade in Services adopted the recognition guidelines developed by the WPPS on May 29, 1997. *See* Press Release, WTO, WTO Adopts Guidelines for Recognition of Qualifications in the Accountancy Sector (May 29, 1997), *available at* http://www.wto.org/english/news_e/pres97_e/pr73_e.htm (last visited Apr.

Council for Trade in Services implemented the Decision on Professional Services by adopting it verbatim at its first meeting on March 1, 1995.[80]

On December 4, 1998, almost four years after its creation and about one and one half years after issuing its *Guidelines for Mutual Recognition Agreements or Arrangements in the Accountancy Sector*,[81] the WPPS completed its work on multilateral disciplines for the accountancy sector.[82] The Council for Trade in Services wasted little time in approving the work of the WPPS and ten days later, on December 14, 1998, adopted the disciplines as submitted by the working party.[83] Development of the *Accountancy Disciplines* was, however, to be the final achievement of the WPPS because on April 26, 1999, it was replaced by the WPDR.[84] The WPDR has continued the work of the WPPS, but its remit is wider, not being limited, as was the WPPS, to developing disciplines only for the professional services sectors.[85]

Several reasons have been advanced for the decision to disband the WPPS in favor of the WPDR. For instance, it has been suggested that the move was prompted by the desire to allow for greater participation of smaller countries that typically do not have the resources to engage in negotiations in more than one forum.[86] The view has also been expressed that the development of disciplines should proceed on a horizontal rather than a sectoral basis, and that the *Accountancy Disciplines* could provide a useful template for such an endeavor.[87] Whatever the motivation, given the wide definition of services

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6, 2005); *see also* WTO Council for Trade in Services, *Guidelines for Mutual Recognition Agreements or Arrangements in the Accountancy Sector*, S/L/38 (May 28, 1997). Although the development of these *Guidelines* was an important step in the post-GATS negotiations, a discussion of them is well beyond the scope of this Article. For an excellent treatment with reference to the relevant WTO documents, see Terry, *supra* note 13, at 1027-29.

80. WTO Council for Trade in Services, *Decision on Professional Services*, S/L/3 (Apr. 4, 1995).

81. *See supra* note 79.

82. Working Party on Professional Services, *Report to the Council for Trade in Services on the Development of Disciplines on Domestic Regulation in the Accountancy Sector*, S/WPPS/4 (Dec. 10, 1998).

83. WTO Council for Trade in Services, *Decision on Disciplines Relating to the Accountancy Sector*, S/L/63 (Dec. 15, 1998) [hereinafter *Decision on Accountancy Disciplines*]; *see also Accountancy Disciplines*, *supra* note 18.

84. *See* WTO Council for Trade in Services, *Decision on Domestic Regulation*, S/L/70 (Apr. 28, 1999).

85. *See id.* ¶ 2.

> In accordance with paragraph 4 of Article VI of the GATS, the Working Party shall develop any necessary disciplines to ensure that measures relating to licensing requirements and procedures, technical standards and qualification requirements and procedures do not constitute unnecessary barriers to trade in services. This shall also encompass the tasks assigned to the Working Party on Professional Services, including the development of general disciplines for professional services as required by paragraph 2 of the Decision on Disciplines Relating to the Accountancy Sector (S/L/63).

Id.

86. *See* Terry, *supra* note 13, at 1038 n.141 (reporting the views Bernard Ascher, Director of Service Industry Affairs for the Office of the United States Trade Representative).

87. *See* Working Party on Professional Services, *Note on the Meeting Held on 9 February*

adopted by the GATS,[88] and the nearly four years that it took the WPPS to develop the *Guidelines for Mutual Recognition Agreements* and the *Accountancy Disciplines*,[89] it simply might not be feasible to expect the WPDR to develop multilateral disciplines on a sectoral basis.

Not surprisingly then, most of the discussion in the WPDR since its creation has focused upon the feasibility of developing horizontal disciplines that could apply to multiple, or perhaps all, services sectors.[90] This development has drawn the ire of many lawyers and bar leaders from around the world.[91] They seem particularly hostile to the suggestion that the *Accountancy Disciplines* might form the basis for multilateral disciplines to govern trade in legal services.[92] These criticisms and the key provisions of the *Accountancy Disciplines* to which they refer are the focus of Part IV.

IV. THE DISCIPLINES ON DOMESTIC REGULATION IN THE ACCOUNTANCY SECTOR: KEY PROVISIONS AND CRITICISMS

A. The Legal Effect and Scope of the Accountancy Disciplines

Before considering their substantive provisions,[93] it is important to note two preliminary issues regarding the *Accountancy Disciplines*, namely their legal status within the GATS regime and the undertakings to which they apply. The legal effect of the *Accountancy Disciplines* was first taken up in the WPPS, which recommended that the *Disciplines* be implemented through a decision of the Council for Trade in Services.[94] Adopting the WPPS's proposed Decision verbatim,[95] the Council for Trade in Services accepted the *Accountancy Disciplines* as drafted by the WPPS, and made them applicable to all Members that placed accountancy services on their Schedules of Specific Commitments.[96] The full implementation of the *Disciplines* into the GATS

1999, S/WPPS/M/25 (Mar. 5, 1999) ("It was also the view of most speakers that work should proceed on a horizontal rather than a sectoral basis, and that the accountancy disciplines would provide a useful starting point for such work.").

88. *See supra* note 29 and accompanying text.

89. The WPPS was created on March 1, 1995, and the *Accountancy Disciplines* were adopted by the Council for Trade in Services on December 14, 1998. *See supra* notes 80-83 and accompanying text.

90. *See* Terry, *supra* note 13, at 1041 (citing minutes of WPDR meetings).

91. *See infra* Part IV.B.

92. *See infra* note 102 and accompanying text.

93. *See infra* notes 107-127 and accompanying text.

94. *See* Working Party on Professional Services, *supra* note 82, ¶ 6. "Members extensively discussed the question of potential legal forms for adoption of the accountancy disciplines. The outcome of the discussions is the attached draft Council Decision (Job No. 6481/Rev.1), which the WPPS now recommends for adoption." *Id.*

95. *Compare id.* ¶ *2 with Decision on Accountancy Disciplines*, *supra* note 83.

96. *Decision on Accountancy Disciplines*, *supra* note 83, ¶ 1. "The Council for Trade in Services . . . Decides as follows, to adopt the text of the Disciplines on Domestic Regulation in

was, nevertheless, delayed until completion of the current round of services negotiations.[97] Instead, the Council's Decision created an immediate standstill effect, which continues to prohibit Member States from adopting domestic regulations that are inconsistent with the *Disciplines*.[98]

Despite the broad language of this standstill paragraph, the *Accountancy Disciplines* were not intended to govern all Member State obligations under the GATS. The first paragraph of the *Disciplines* expressly states that theses measures only apply to "domestic regulations" and not to the market access and national treatment limitations enshrined in Members States' schedules.[99] While the distinction between domestic regulations and market access and national treatment obligations might be easy enough to state in the abstract, categorizing a regulation in a particular case may be exceedingly difficult.[100]

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the Accountancy Sector contained in document S/WPPS/W/21. These disciplines are to be applicable to Members who have entered specific commitments on accountancy in their schedules." *Id.*

97. *Id.* ¶ 2 ("No later than the conclusion of the forthcoming round of services negotiations, the disciplines developed by the WPPS are intended to be integrated into the General Agreement on Trade in Services (GATS).").

98. *Id.* ¶ 3 ("Commencing immediately and continuing until the formal integration of these disciplines into the GATS, Members shall, to the fullest extent consistent with their existing legislation, not take measures which would be inconsistent with these disciplines.").

99. *Accountancy Disciplines*, *supra* note 18, ¶ 1.

> The purpose of these disciplines is to facilitate trade in accountancy services by ensuring that domestic regulations affecting trade in accountancy services meet the requirements of Article VI:4 of the GATS. The disciplines therefore do not address measures subject to scheduling under Articles XVI and XVII of the GATS, which restrict access to the domestic market or limit the application of national treatment to foreign suppliers. Such measures are addressed in the GATS through the negotiation and scheduling of specific commitments.

Id. Accord Working Party on Professional Services, *Discussion of Matters Relating to Articles XVI and XVII of the GATS in Connection with the Disciplines on Domestic Regulation in the Accountancy Sector: Informal Note by the Chairman* (Job No. 6496), *attached to* S/WPPS/4 (Nov. 25, 1998) ¶ 2 [hereinafter Chairman's Note].

> In the course of work to develop multilateral disciplines on domestic regulation in the accountancy sector, pursuant to paragraph 4 of Article VI of the GATS, the WPPS addressed a wide range of regulatory measures which have an impact on trade in accountancy services. In discussing the structure and content of the new disciplines, it became clear that some of these measures were subject to other legal provisions in the GATS, most notably Articles XVI and XVII. *It was observed that the new disciplines developed under Article VI:4 must not overlap with other provisions already existing in the GATS, including Articles XVI and XVII, as this would create legal uncertainty.* For this reason, a number of the suggestions for disciplines were excluded from the text.

Id. (emphasis added).

100. This much was recognized, and a justification for the distinction given, in Chairman's Note, *supra* note 99, ¶ 3:

> Although it was not in the mandate of the WPPS to provide an interpretation of GATS provisions, the important relationship between the new disciplines and Articles XVI and XVII was noted. While these two Articles relate to the scheduling of specific commitments on measures falling within their scope, the disciplines developed under Article VI:4 aim at ensuring that other types of regulatory measures do not create unnecessary barriers to trade. It has been

In fact, this overlap could serve to narrow the scope of the *Accountancy Disciplines* even further by allowing a Member State to make a colorable argument that what appears to be a domestic regulation provision is really a market access or national treatment limitation that it can maintain pursuant to the terms of its schedule. Much of this confusion perhaps arises from the uncertain parameters of the term "domestic regulation." Through GATT practice, Member States have a pretty good idea of the meaning of "market access" and "national treatment." Adding flesh to the bones of the "domestic regulation" concept may similarly have to await further GATS practice and interpretation of the term in the adjudicative bodies of the WTO.

B. The Accountancy Disciplines and Their Critics

As previously noted, since its inception, much of the work of the WPDR has focused on the feasibility of using the *Accountancy Disciplines* as a model for developing horizontal disciplines that could apply to all services sectors.[101] Many bar leaders have criticized this development, and some have expressed their dismay in position papers that catalogue misgivings about the appropriateness of applying the *Disciplines* to trade in legal services.[102] Three

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> noted that Article XVI (Market Access) covers the categories of measures referred to in paragraph 2 (a) to (f), whether or not any discrimination is made in their application between domestic and foreign suppliers. Article XVII (National Treatment) captures within its scope any measure that discriminates—whether *de jure* or *de facto*—against foreign services or service suppliers in favour of like services or service suppliers of national origin. A Member scheduling commitments under Articles XVI and XVII has the right to maintain limitations on market access and national treatment and inscribe them in its schedule. On the other hand, the disciplines to be developed under Article VI:4 cover domestic regulatory measures which are not regarded as market access limitations as such, and which do not in principle discriminate against foreign suppliers. They are therefore not subject to scheduling under Articles XVI and XVII. *However, it is also recognized that for some categories of measures the determination as to whether an individual measure falls under Article VI:4 disciplines or is subject to scheduling under Article XVII will require careful consideration.*

Id. (emphasis added). *But see* Terry, *supra* note 13, at 1073 (questioning whether a Member State could continue to rely on market access and national treatment standstill provisions in its Schedule of Specific Commitments if sectoral disciplines are adopted).

101. *See supra* note 90 and accompanying text.

102. *See, e.g.*, CAN. BAR ASS'N, SUBMISSION ON: THE GENERAL AGREEMENT ON TRADE IN SERVICES AND THE LEGAL PROFESSION: THE ACCOUNTANCY DISCIPLINES AS A MODEL FOR THE LEGAL PROFESSION (Aug. 2000), http://www.cba.org/cba/submissions/pdf/00-30-eng.pdf (last visited Apr. 6, 2005) [hereinafter CBA GATS Submission]; COUNCIL OF THE BARS & LAW SOCIETIES OF THE EUROPEAN UNION, CCBE RESPONSE TO THE WTO CONCERNING THE APPLICABILITY OF THE ACCOUNTANCY DISCIPLINES TO THE LEGAL PROFESSION (May 2003), http://www.ccbe.org/doc/En/ccbe_response_080503_en.pdf (last visited Apr. 6, 2005) [hereinafter CCBE Response]; FED'N OF LAW SOCIETIES OF CAN., MEETING CANADA'S CURRENT OBLIGATIONS FOR THE LEGAL PROFESSION UNDER THE GENERAL AGREEMENT ON TRADE IN SERVICES (GATS) OF THE WORLD TRADE ORGANIZATION (WTO) (Feb. 24, 2001), http://www.flsc.ca/en/documents/2001wtoreport.doc (last visited Apr. 6, 2005) [hereinafter Meeting Canada's Current Obligations].

organizations in particular have been very active in expressing their concerns and encouraging their members to become involved in the GATS negotiations.[103] They include the Canadian Bar Association (CBA),[104] the Federation of Law Societies of Canada (FLSC),[105] and the Council of the Bars and Law Societies of the European Union (CCBE).[106] Their criticisms provide a measure of where compromise might be possible, and they also suggest the difficulty that lies ahead in reaching a consensus on appropriate disciplines for the legal services sector.

The provisions of the *Disciplines* that deal with the procedural aspects of licensing have been relatively uncontroversial.[107] These provisions have raised few concerns among bar associations largely because the prescribed practices are already followed by many licensing authorities.[108] Other provisions that fall into this category include Article V (Licensing Procedures)[109] and Article VII

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103. For a discussion of the failure of the U.S. legal community to take such an interest, see Terry, *Why You Should Care*, *supra* note 14, at 67.

104. "The Canadian Bar Association is a professional, voluntary organization which was formed in 1896, and incorporated by a Special Act of Parliament on April 15, 1921. Today, the Association represents some 38,000 lawyers, judges, notaries, law teachers, and law students from across Canada. Approximately two-thirds of all practising lawyers in Canada belong to the CBA." Can. Bar Ass'n, *About the CBA*, *at* http://www.cba.org/CBA/about/main/ (last visited Feb. 12, 2005).

105. "The Federation of Law Societies of Canada is the umbrella organization of the fourteen Law Societies in Canada. Each law society governs the legal profession within their respective province or territory." Fed'n of Law Societies of Can., *A Word From the President*, *at* http://www.flsc.ca/en/about/president.asp (last visited Feb. 12, 2005).

106. "The CCBE liaises between the Bars and Law Societies from the Member States of the European Union and the European Economic Area. It represents all such Bars and Law Societies before the European institutions, and through them some 500,000 European lawyers." Comm'n Consultative des Barreaux Européens, *What is the CCBE?*, *at* http://www.ccbe.org/en/ccbe/ccbe_en.htm (last visited Apr. 6, 2005). CCBE is the acronym for the Commission Consultative des Barreaux Européens, which, although later named the Council of the Bars and Law Societies of the European Community, was still known colloquially as the CCBE. CONE, *supra* note 17, at § 2:6.

107. *See, e.g.*, *Accountancy Disciplines*, *supra* note 18, ¶ 3 (on transparency). "Members shall make publicly available, including through the enquiry and contact points established under Articles III and IV of the GATS, the names and addresses of competent authorities (i.e., governmental or non-governmental entities responsible for the licensing of professionals or firms, or accounting regulations)." *Id.*

108. *See, e.g.*, Meeting Canada's Current Obligations, *supra* note 102, at 13. "Canadian Law Societies already comply with Discipline 3 as they do make publicly available the names and addresses of competent authorities who license and regulate lawyers within Canada. Such information can be obtained directly from the respective Law Society or from the Federation of Law Societies of Canada." *Id.*

109. *See, e.g.*, *Accountancy Disciplines*, *supra* note 18, ¶ 15.

> Application procedures and the related documentation shall not be more burdensome than necessary to ensure that applicants fulfill qualification and licensing requirements. For example, competent authorities shall not require more documents than are strictly necessary for the purpose of licensing, and shall not impose unreasonable requirements regarding the format of documentation. Where minor errors are made in the completion of applications, applicants shall

(Qualification Procedures).[110] Nevertheless, several other provisions have raised alarm among bar leaders.

The first discipline that has been singled out as raising some concern is found in Article II (General Provisions), which provides:

> Members shall ensure that measures not subject to scheduling under Articles XVI or XVII of the GATS, relating to licensing requirements and procedures, technical standards and qualification requirements and procedures are not prepared, adopted or applied with a view to or with the effect of creating unnecessary barriers to trade in accountancy services. For this purpose, *MEMBERS SHALL ENSURE THAT MEASURES ARE NOT MORE TRADE-RESTRICTIVE THAN NECESSARY TO FULFIL A LEGITIMATE OBJECTIVE.* Legitimate objectives are, *INTER ALIA*, the protection of consumers (which includes all users of accounting services and the public generally), the quality of the service, professional competence, and the integrity of the profession.[111]

The principal criticisms of this discipline focus on use of the terms "necessary" and "legitimate objective." The CBA, in particular, is concerned that the WTO adjudicative bodies would rely on the WTO's interpretation of the word "necessary" under Article XX of the GATT in construing the obligation imposed on Member States in this discipline.[112] The CBA reads this Article XX jurisprudence as requiring a Member State to establish that there "were no alternative measure[s] consistent with the General Agreement, or less inconsistent with it" in order to maintain a challenged regulation.[113] Moreover, it worried because, "[i]n the dozen or so cases which have been decided under Article XX, a member state's measure has never been upheld on grounds of 'necessity'."[114] Interpretive discretion also motivates the CBA's concern over the notion of "legitimate objective." It opined: "Although the Article lists

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> be given the opportunity to correct them. The establishment of the authenticity of documents shall be sought through the least burdensome procedure and, wherever possible, authenticated copies should be accepted in place of original documents.

Id.

110. *See, e.g., id.* ¶ 22 ("Verification of an applicant's qualifications acquired in the territory of another Member shall take place within a reasonable time-frame, in principle within six months and, where applicants' qualifications fall short of requirements, shall result in a decision which identifies additional qualifications, if any, to be acquired by the applicant."); *see also* CBA GATS Submission, *supra* note 102, at 7-8 (describing Article V (Licensing Procedures) and Article VII (Qualification Procedures) as "provisions which do not raise concerns").

111. *Accountancy Disciplines*, *supra* note 18, ¶ 2 (emphasis added).

112. CBA GATS Submission, *supra* note 102, at 9-10.

113. *Id.* at 9. (quoting Thailand – Restrictions on Importation of and Internal Taxes on Cigarettes, Nov. 7, 1990, GATT B.I.S.D. (37th Supp.) at 223, ¶ 75 (1990)).

114. *Id.*

examples of legitimate objectives . . . we remain concerned that 'legitimate objective' can be interpreted broadly or narrowly by a dispute panel. More clarification is required to ensure the profession's self-regulating bodies retain a sufficient level of discretion."[115]

From the perspective of legal regulators perhaps the most nettlesome provision of the *Accountancy Disciplines* is found in Article VI (Qualification Requirements), which states in relevant part: 19. A Member shall ensure that its competent authorities take account of qualifications acquired in the territory of another Member, on the basis of equivalency of education, experience and/or examination requirements.

> 19. The scope of examinations and of any other qualification requirements shall be limited to subjects relevant to the activities for which authorization is sought. Qualification requirements may include education, examinations, practical training, experience and language skills.[116]

The reason that these two provisions have raised concern lies in the jurisdiction-specific nature of legal rules. For example, with respect to paragraph 19, the CBA believes that "[i]t is unlikely that foreign qualifications will be of great relevance to the practice of law in Canada. This is particularly true of those who intend to practice host-country law or represent clients before courts and tribunals."[117] This conviction has led the CBA to conclude that "[t]his provision . . . is out of place in the context of disciplines for the legal profession."[118] The CCBE, in contrast, has taken a more nuanced position with respect to paragraph 19, owing to its "experience . . . in relation to qualification requirements."[119] While it concluded that paragraph 19 is generally acceptable,[120] it nonetheless cautioned that an EC-style approach to recognition

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115. *Id.* at 10. *But see* Terry, *supra* note 13, at 1031, noting:

> In my view, one of the concrete accomplishments of the *Disciplines* is that it provides a definition of what constitutes a "legitimate objective." While some may disagree with this definition, the fact that a definition exists makes it more likely that countries will be using the same standards to explain their disagreements, even if they apply those standards differently.

Id.

116. *Accountancy Disciplines*, *supra* note 18, ¶¶ 19-20.

117. CBA GATS Submission, *supra* note 102, at 14.

118. *Id.*

119. CCBE Response, *supra* note 102, at 7 (referring to language in paragraphs 19 and 20 that reflects provisions in the European Community's own "Diplomas Directive"). *See generally* Council Directive 89/48/EEC, 1989 O.J. (L 19) 16 (Council Directive of December 21, 1988 on General System for the Recognition of Higher Education Diplomas).

120. CCBE Response, *supra* note 102, at 8 ("Paragraph 19, with its general duty to take account of foreign qualifications, should be deemed acceptable, and in any case it is unlikely that the WTO would ever consider it fair to have it excluded for lawyers.").

of qualifications is inappropriate given the diversity of educational and professional qualifications required of the world's legal professionals.[121]

The principal objection to paragraph 20, which deals with the scope of qualification requirements, is that many legal professions are not divisible into specific areas of practice. The CBA noted:

> Law societies in Canada and the governing bodies in many foreign jurisdictions qualify lawyers "at large" to practise in any field .... The "activity for which authorization is sought" is therefore to be a full member of the bar, not to be a business lawyer or a criminal lawyer or a labour relations lawyer. Indeed, this makes a good deal of sense, as there is a good deal of cross-pollination between areas of the law.[122]

Thus, once again, the CBA concluded that, "[i]n the context of the legal profession, this provision is not appropriate."[123]

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121. *Id.*

> The second comment is that the EU is accustomed to the notion of taking into account prior qualifications obtained in another EU Member State. The exercise is based on the assumption that lawyers qualify in similar ways, to a similar standard and with the same range of activities in all Member States. It may be safe to make that assumption in the EU, but it is a much more difficult assumption to make when the whole world is involved. In the EU, as a result, there is no trawling through the specific qualifications, subjects, university attended and results obtained from elsewhere in the EU, because of the underlying common assumption. If that were to be extended around the world, it would involve the bars and law societies in one of two options. Either, they would have to make the same common assumption that is made in the EU about the qualifications brought to them across borders. That is doubtless an unsafe assumption to make about the whole world. Or, they would have to establish a system whereby they could recognize each degree, each title, each university from each country. That is a very time-consuming and resource-rich exercise.

Id.

122. CBA GATS Submission, *supra* note 102, at 14; *accord* CCBE Response, *supra* note 102, at 7.

> The first comment is to stress that the phrase "limited to subjects relevant to the activities for which authorization is sought" is capable of meaning only one thing in the legal profession. It is not believed that anywhere in the world are foreign lawyers able to acquire a host qualification or title (as opposed to an ability to practise under home title) which is limited to a particular area. In other words, if a lawyer is going to requalify and acquire the host title, it is the whole of the host title of lawyer which is acquired on requalification, enabling the foreign lawyer to carry out all the activities of the host lawyer. There is no alternative, lesser activity which can be obtained.

Id.

123. CBA GATS Submission, *supra* note 102, at 14; *accord* CCBE Response, *supra* note 102, at 8 ("paragraph 20 sets an impractical standard for bars and law societies, and should be deleted").

Lastly, some bar associations have expressed their desire to modify the provisions in Article VIII (Technical Standards). This Article provides:

> 25. Members shall ensure that measures relating to technical standards are prepared, adopted and applied only to fulfil legitimate objectives.
>
> 26. In determining whether a measure is in conformity with the obligations under paragraph 2, account shall be taken of internationally recognized standards of relevant international organizations applied by that Member.[124]

The bar associations' difficulty with these provisions is part definitional. As the CCBE has noted, "the phrase 'technical standards' is the wrong one to apply to the legal profession. What lawyers have are ethical rules, competency requirements, and qualification requirements."[125] The CBA, however, further remonstrated against this provision by contending that standards of ethics and professional conduct "should not be subject to third-party review to determine whether they fulfil 'legitimate objectives,'" and that "given the jurisdiction-specific nature of laws and legal systems, there are no internationally recognized standards of relevant international organizations with respect to the practise of law."[126]

The three objections to the *Accountancy Disciplines* highlighted above, namely, those relating to the general scheme of the *Disciplines*, those relating to the provisions on qualifications requirements, and to those that might potentially regulate ethical standards and professional competence, are by no means the only criticisms that have been lodged.[127] They have been chosen for discussion, however, because they are the most prominent, and also because they represent areas of disagreement where the potential for compromise might be greatest. In fact, more significant than any particular objection to the *Accountancy Disciplines* is the manner in which those objections have been expressed. Specifically, bar associations have used the language of "core values" to express their concerns about the *Disciplines*. The consequences of this particular form of expression are addressed in Part V.

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124. *Accountancy Disciplines*, *supra* note 18, at ¶¶ 25-26.

125. CCBE Response, *supra* note 102, at 9.

126. CBA GATS Submission, *supra* note 102, at 15.

127. *See, e.g.*, CBA GATS Submission, *supra* note 102, at 11-14 (detailing the CBA's objections to the *Accountancy Disciplines*' limits on Member States' use of residency requirements, membership in professional organizations, and restrictions on use of firm names to circumscribe foreign lawyers' rights of practice).

V. THE ACCOUNTANCY DISCIPLINES AND THE LANGUAGE OF CORE VALUES: EVALUATING THE CRITICISMS OF NATIONAL BAR ASSOCIATIONS

There are at least two means by which the criticisms of national bar associations may be evaluated. First, they may be evaluated on their own terms; that is, one might inquire whether the bar associations' concerns are reasonable in light of WTO practice, national regulatory interests, and other factors that influence the regulation of trade in legal services. Second, one might ask whether the language employed by some national bar associations and their general approach to the domestic regulation negotiations serves to foster compromise, or whether their positions instead stifle meaningful debate. Both of these methods are employed below to assess the bar associations' critiques.

A. Do the Bar Association Critiques of the Accountancy Disciplines Reflect Legitimate Concerns?

The intent of this subsection is not to question the good-faith concerns that national bar associations possess with regard to the *Accountancy Disciplines* or to suggest that there is a "right" solution to any of these very difficult issues. Rather, it is intended to show that there is more room for compromise on most of the bar associations' specific concerns than is evident at first blush. For example, the CBA and the CCBE have raised concerns about the interpretation of the word "necessary" in the context of GATT Article XX.[128] They worry that interpretation of the term "necessary" in the *Accountancy Disciplines*[129] will require a regulatory measure to be the "least trade restrictive" available to national authorities. This concern may ultimately be borne out, but it ignores the Appellate Body's recent Article XX jurisprudence and the more nuanced approach that it has employed in interpreting the term "necessary."[130] In *KOREA – BEEF*,[131] the Appellate Body stated:

> We believe that, as used in the context of Article XX(d), the reach of the word "necessary" is not limited to that which is

128. *See supra* notes 112-115 and accompanying text.

129. *See Accountancy Disciplines*, *supra* note 18, at ¶ 2 ("Members shall ensure that measures . . . are not prepared, adopted or applied with a view to or with the effect of creating unnecessary barriers to trade in accountancy services.").

130. *See* CCBE Response, *supra* note 102, at 4-5. The CCBE position, which is essentially the same as that of the CBA, is assailable on these grounds because it was not released until May 2003, well after the cases considered below. *See infra* notes 131-32 and accompanying text. However, this omission can be excused in the case of the CBA GATS Submission given that it was released in August 2000, before the most recent Appellate Body cases on Article XX were decided.

131. WTO Appellate Body Report, *Korea – Measures Affecting Imports of Fresh, Chilled and Frozen Beef*, WT/DS161/AB/R & WT/DS169/AB/R (Dec. 11, 2000).

> "indispensable" or "of absolute necessity" or "inevitable." Measures which are indispensable or of absolute necessity or inevitable to secure compliance certainly fulfil the requirements of Article XX(d). But other measures, too, may fall within the ambit of this exception. As used in Article XX(d), the term "necessary" refers, in our view, to a range of degrees of necessity. At one end of this continuum lies "necessary" understood as "indispensable"; at the other end, is "necessary" taken to mean "making a contribution to."[132]

The point here is not that the bar associations' critiques are wide of the mark, but simply that there is another perspective from which to view these issues, and which may provide the "wiggle room" necessary to successfully complete the disciplines track negotiations.

The bar associations' position with respect to the disciplines on qualification requirements also admits of some room for negotiation. For example, the CBA has declared the discipline requiring governing bodies to "take into account . . . qualifications acquired in the territory of another"[133] inappropriate in the context of legal services.[134] This position, however, fails to account for the fact that Canada's law societies already take foreign qualifications into account in licensing foreign legal consultants.[135] As if to recognize that there is room for compromise on this issue, the CBA eventually concedes that "so long as it [is] clear [that] member states are merely required to 'take into account' foreign qualifications, this provision may not be overly problematic."[136] Likewise, the CBA's and CCBE's insistence on the full qualification of foreign lawyers[137] ignores the experience with foreign legal consultant rules over the past thirty years, virtually all of which permit practice in certain areas of the law while restricting it in others.[138]

Lastly, the bar associations' critique of the "technical standards" discipline bears some attention. The Federation of Law Societies of Canada has stated as apparent fact:

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132. *Id.* ¶ 161; *see also European Communities – Measures Affecting Asbestos and Asbestos-Containing Products*, WT/DS135/AB/R (Mar. 12, 2001) (applying its *Korea – Beef* analysis to the interpretation of Article XX(b), the Appellate Body upheld a French import ban on chrysotile asbestos products as "necessary to protect . . . human life or health").

133. *Accountancy Disciplines*, *supra* note 18, ¶ 19.

134. *See supra* note 118 and accompanying text.

135. *See* Meeting Canada's Current Obligations, *supra* note 102, at 18 ("Foreign Legal Consultants are licensed on the basis of their foreign credentials and their membership in good standing of a law society or bar association of another country.").

136. CBA GATS Submission, *supra* note 102, at 14.

137. *See supra* note 122 and accompanying text.

138. *See infra* Part VI.B (discussing the ABA Model Rule for the Licensing of Legal Consultants).

> There are no recognized relevant international organizations which set out internationally recognized standards for the legal profession, or recognized rules of professional conduct and standards of professional competence. . . . [T]his is in part a result of the differing underlying legal systems. . . . This Discipline is therefore of no application to the legal services sector.[139]

As the CCBE has recognized, such a position ignores "the CCBE's Code of Conduct for cross-border transactions in Europe, the IBA's Code of Conduct, plus doubtless [sic] other standards of international bodies dealing with single issues of arbitration or insolvency."[140] By raising the profile of these international efforts and by demonstrating to national regulators how these multilateral codes could help ensure the competence and professionalism of international legal practitioners, it might be possible to reach some common ground on this discipline as well.

As stated above, the point here is not to suggest that the bar associations are "wrong" in their criticisms of the *Accountancy Disciplines* from a normative standpoint. From a policy perspective, it is clear that the bar associations have expressed legitimate concerns and that reasonable people could disagree about the kinds of regulations that might best govern the international trade in legal services. In fact, given that the *Accountancy Disciplines* are once again the subject of negotiations in the WPDR it is entirely proper that there exists competing visions of how best to implement them in the various services sectors. Such a development will allow for the necessary "give and take" that may ultimately result in an appropriate accommodation.

B. Do the Accountancy Disciplines Undermine the Core Values of the Legal Profession?

The differences of opinion on specific provisions of the *Accountancy Disciplines* are not, however, the whole story. The bar associations have also suggested more broadly that the *Disciplines* fail to respect the "core values" of the legal profession. Whereas the differences of opinion noted in the previous

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139. Meeting Canada's Current Obligations, *supra* note 102, at 20; *see also* CBA GATS Submission, *supra* note 102, at 15 ("[G]iven the jurisdiction-specific nature of laws and legal systems, there are no internationally recognized standards of relevant international organizations with respect to the practise of law.").

140. CCBE Response, *supra* note 102, at 9. For a comprehensive discussion of the CCBE Code of Conduct, see Laurel S. Terry, *An Introduction to the European Community's Legal Ethics Code Part I: An Analysis of the CCBE Code of Conduct*, 7 GEO. J. LEGAL ETHICS 1 (1993); Laurel S. Terry, *An Introduction to the European Community's Legal Ethics Code Part II: Applying the CCBE Code of Conduct*, 7 GEO. J. LEGAL ETHICS 345 (1993). For an argument that the CCBE Code of Conduct could provide a model for a worldwide ethics code, see John Toulmin Q.C., *A Worldwide Common Code of Professional Ethics?*, 15 FORDHAM INT'L L.J. 673 (1991-92).

section might serve to propel the negotiations forward, the differences of opinion that are seen to stem from "core values" are destructive of consensus and could undermine the disciplines track negotiations.

1. The Criticisms of National Bar Associations and the Language of "Core Values"

In cataloging the unique features of the legal profession that render the *Accountancy Disciplines* inappropriate for application to the legal services sector, the CCBE began by noting:

> The general feeling of lawyers is that the core values and specific characteristics of the profession are not taken into account in the present *DISCIPLINES.* Although there may be debate over what exactly the core values are, most lawyers around the world agree that they include the following: independence, confidentiality, and the avoidance of conflict of interest.[141]

To the "core values" recognized by the European Bar, the Canadian Bar has added competence,[142] self-regulation,[143] the duty of undivided loyalty,[144] and the solicitor-client privilege.[145] Further, the CBA has asserted that these

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141. CCBE Response, *supra* note 102, at 3; *accord* Meeting Canada's Current Obligations, *supra* note 102, at 6, 11 (suggesting that, "as currently drafted, the Disciplines are an inadequate expression of the culture and values inherent in the legal profession," and identifying the "unique values" of the legal profession as including independence, self-governance, client confidentiality, and conflict of interest).

142. CBA GATS Submission, *supra* note 102, at 3 ("[T]he public interest requires lawyers to be subject to standards of competence and professional conduct and demands an objective regulatory structure to ensure lawyers observe these standards.").

143. *Id.* at 4 ("To ensure independence from state interference, the legal profession must be self-regulating.").

144. *Id.* at 5 ("Canadian lawyers owe a duty of undivided loyalty to their clients and do not serve, as do some professions, as instruments of the state's control or supervision of its citizens....").

145. *Id.* ("[E]xcept in the rarest of circumstances, the legal doctrine of solicitor-client privilege prevents third parties, including government authorities, from forcing the lawyer to reveal these confidential communications."); *see also* ABA Core Values Resolution, *supra* note 16.

> RESOLVED, that each jurisdiction is urged to revise its law governing lawyers to implement the following principles and preserve the core values of the legal profession:
>
> 1. It is in the public interest to preserve the core values of the legal profession, among which are:
>   a. the lawyer's duty of undivided loyalty to the client;
>   b. the lawyer's duty competently to exercise independent legal judgment for the benefit of the client;
>   c. the lawyer's duty to hold client confidences inviolate;

values "do not simply derive from a set of rules laid down by a professional body. Rather, they are *centuries-old principles which have developed to ensure the proper functioning of the legal system.*"[146]

The lawyer's role in society is also cited as a distinguishing characteristic of the legal profession. The CBA notes that "[t]he legal profession has unique characteristics arising from its role as intermediary between the citizen and the law and between the citizen and the state."[147] In fact, the CBA believes that "the unique role of lawyers makes the obligations of the legal professional more of *a social imperative.*"[148] This position has led it to conclude, in rather grandiose language, that legal services "should not be covered by a common generic set of professional disciplines, as this would *threaten a central pillar in the kind of society Canadians have been striving to create and improve.*"[149]

Moreover, the value choices inherent in the jurisdiction-specific nature of legal rules are often advanced as another reason why horizontal disciplines may not be suitable for the legal profession:

> The education, practical training and other qualifications of a lawyer relate, to a substantial extent, to a particular national legal system. Thus, unlike medicine or engineering, where the applicable principles are exactly the same from one country to another, or accounting, where the rules tend to vary somewhat in their details but are readily subject to reconciliation in accordance with common principles, law is highly variable from one jurisdiction to the next and, *AS AN EXPRESSION OF THE MORES AND MUTUAL EXPECTATIONS OF THE CITIZENS, IS SIGNIFICANTLY CULTURAL IN ITS CONTENT.*[150]

It might be tempting to dismiss these statements as merely hortatory language that is unlikely to have much effect on the current negotiations in the WPDR. But another way to look at them is as an assertion of regulatory independence; a shot across the bow in answer to the central question of these

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d. the lawyer's duty to avoid conflicts of interest with the client; and
e. the lawyer's duty to help maintain a single profession of law with responsibilities as a representative of clients, an officer of the legal system, and a public citizen having special responsibility for the quality of justice.
f. the lawyer's duty to promote access to justice.

Id.

146. CBA GATS Submission, *supra* note 102, at 5 (emphasis added).
147. *Id.* at 1.
148. *Id.* at 5 (emphasis added).
149. *Id.* at 3 (emphasis added).
150. INT'L BAR ASS'N, STANDARDS AND CRITERIA FOR RECOGNITION OF THE PROFESSIONAL QUALIFICATIONS OF LAWYERS 3 (June 2001), http://www.ibanet.org/images/downloads/Standards%20and%20Criteria%20for%20Recognition%20of%20Qualifications%20of%20Lawyers%2001.pdf (last visited Apr. 6, 2005).

negotiations: is law a business or a profession?[151] The terms that bar associations have used to express their positions could thus have a real impact on the disciplines negotiations.

2. The Consequences of Reliance on "Core Values"

The principal danger in the bar associations' reliance on the core values of the legal profession to oppose some aspects of the WPDR negotiations is that such language will be used to foreclose discussion on issues where there appears to be some room for compromise. As one commentator observed:

> How does one evaluate the claim that a proposed rule violates a core value of the profession? This issue is important because the term core value indicates a value that is central to what it means to be a lawyer, and not simply a policy choice between differing views of professional obligations. If a proposed rule violates a core value, it follows that the proposal must be rejected because it threatens a fundamental tenet of the profession.[152]

Thus, the bar associations' labeling of the *Accountancy Disciplines* as violative of the core values of the profession might have resulted from two alternative conclusions. On the one hand, bar leaders could legitimately have determined that the *Disciplines* are anathema to their profession and thus

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151. *See* Paton, *supra* note 68, at 395 (noting "the internal contradictions facing the legal profession on the broader question of liberalizing trade in services: is law a business or a profession?").

152. Nathan M. Crystal, *Core Values: False and True*, 70 FORDHAM L. REV. 747, 749 (2001). Professor Crystal has suggested a two-step approach to determining whether a bar norm qualifies as a "core value" of the legal profession:

> First, define precisely the value at issue to eliminate ambiguities and uncertainties about the meaning and scope of the value. Second, analyze whether the value qualifies for treatment as a core value. In making this determination, one should consider both the history and the importance of the value to the professional role. History of the value is significant because it is to be expected that core values find expression early in the history of professional ethics. The importance of the value to the professional role is significant because a value that has only marginal or uncertain importance hardly qualifies as a core value.

Id. Professor Crystal then applied this analytical approach to four putative "core values" of the American legal profession: undivided loyalty, strict confidentiality, promotion of access to justice, and exclusive judicial authority to regulate the practice of law. *Id.* at 750-773. He concluded that none of these four values are "core values" of the American legal profession. *Id.* at 773. Professor Crystal's analysis could provide some much needed understanding in this area of professional ethics. Nevertheless, coming to a conclusion on whether a claimed value is in fact a core value of the profession seems counterproductive in the context of sensitive GATS negotiations. Therefore, the present analysis is more concerned with understanding the consequences of reliance upon core values on the prospects for successfully completing the disciplines track negotiations.

should be rejected. On the other hand, the assertion of core values might be seen as a strategy to allow bar associations to declare their regulatory independence and to walk away from the negotiating table should the talks fail to go their way. There are several statements in the bar associations' own position papers that make the latter view more persuasive than the former.

For instance, at the same time that the CBA was questioning whether international legal services disciplines might violate the core values of the legal profession,[153] it was also touting the Canadian legal profession's prospects for exporting legal services:

> International trade disciplines will likely increase opportunities for Canadian lawyers to practice international law and Canadian law abroad. Canadian law firms are uniquely placed in the international legal market. Canadian lawyers are directly exposed to the two major legal systems of the Western world (civil law in Quebec and common law in the remaining jurisdictions) and they practise in two globally important languages. Canada's legal culture is influenced by that of the United Kingdom and the United States, which are the principal players in the international legal market. Canadian lawyers are also competitive in the international market in terms of cost, skills and experience.[154]

One need not be too cynical to think that such advocacy substantially undermines the argument that the *Disciplines* violate the core values of the legal profession.[155] Instead, the arguments from core values are more accurately seen as bids by national authorities to maintain their traditional grip on regulatory power.[156] Several defiant statements of the Canadian Bar Association seem to confirm this reading of some bar associations' "core values" strategy. For example, in addressing the "necessary" requirement in Article II of the *Accountancy Disciplines*, the CBA stated, "[o]ur view is that

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153. *See generally* CBA GATS Submission, *supra* note 102.

154. CBA GATS Submission, *supra* note 102, at 3.

155. *See* Paton, *supra* note 68, at 411 (noting the "tension within the legal profession in Canada between 'protecting the guild' and desiring more open trade opportunities for exporting legal services . . .").

156. *See* Crystal, *supra* note 152, at 774 ("[T]he appeal to core values has been used in an effort to maintain professional independence from other regulatory forces and to help sustain a professional monopoly over the delivery of legal services."); *see also* Paton, *supra* note 68, at 363-64.

> Resistance to openness in various Canadian proposals and submissions is fundamentally anchored in the notion that the legal profession is unique, or different; that its 'core values' mean that it should lie beyond the scrutiny or attention of trade negotiators in all but a few inconsequential areas relating to the provision of foreign legal services within domestically regulated jurisdictions.

Id.

the legal profession should not have to prove the 'necessity' of rules which it is convinced are required to preserve its integrity and protect the public."[157] Further, it noted that its:

> overall concern is that law society rules concerning matters which relate to the public interest not be subject to review by a third-party dispute settlement body. . . . Such issues of public protection should not be left to a panel of "experts" from other countries with little or no familiarity of Canada's legal history and culture.[158]

So it appears that some bar associations are less concerned that the *Accountancy Disciplines* violate the core values of the legal profession, and are more concerned that they might lose their traditional monopolies over prescribing the precise means by which the core values may be given effect in their respective legal systems.[159]

The point here, once again, is not to make a normative judgment about the correctness of the bar associations' conclusions as to whether the *Accountancy Disciplines* in fact violate the core values of the legal profession, but instead to note that core values arguments present the potential for obfuscation of the underlying issues on the negotiating table.[160] Moreover, placing stock in core values arguments risks advancing the interests of national regulatory monopolies to the detriment of legal consumers.[161]

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157. CBA GATS Submission, *supra* note 102, at 10.

158. *Id.* at 17. *See also* CCBE Response, *supra* note 102, at 4. The CCBE , recommends the insertion of the following language to Article II(2) of the *Disciplines*:

> For the purpose of defining what is 'necessary' in the context of legal services, it is recognised that those entities involved in the regulation of lawyers have an area of reasonable discretion in making decisions which involve the protection of those core values of the profession which fall within legitimate objectives.

Id.

159. *See* Paton, *supra* note 68, at 399.

> [T]he CBA worried that the burden of establishing necessity falls upon the party imposing the restriction, which means that legal regulators would have to justify themselves to external dispute resolution panels, rather than merely having their usual carte blanche to regulate in whatever fashion they decided best served the public interest.

Id.

160. *See* Crystal, *supra* note 152, at 748 (opining that "reliance on core values of the legal profession in debates about legal ethics has rhetorical appeal but is fundamentally misleading").

161. *Id.* (noting that "at a deeper level, reliance on the core values of the profession often reflects an antimarket, anticompetitive attitude of the bar that impedes change in rules of professional conduct . . .").

VI. THE GATS, CORE VALUES, AND THE AMERICAN LAWYER: INTEGRATING MULTI-JURISDICTIONAL LEGAL PRACTICE AND NATIONAL ETHICAL STANDARDS

Although the American Bar Association (ABA) has been slow to stake out a public position on the current WPDR "disciplines" negotiations,[162] one is not without some evidence of how the ABA might weigh the core values of the American legal profession, on the one hand, against the relative benefits of liberalized legal services markets, on the other. The ABA *Model Rules of Professional Conduct*,[163] in many ways, forms the normative ethical basis for American lawyers, and suggests the U.S. legal community's views of its own core values.[164] Moreover, recent developments within the ABA, like the promotion of the ABA *Model Rule for the Licensing of Legal Consultants*,[165] could offer a point of compromise in the disciplines track negotiations by advancing the notion that greater liberalization of the legal services sector might be achieved through the bifurcation of lawyer regulatory regimes into domestic and cross-border elements. Some of the core values expressed in the Model Rules[166] and recent developments within the ABA are each considered below.

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162. *See supra* note 14 and accompanying text.

163. The Model Rules were adopted by the ABA House of Delegates on August 2, 1983. They have been amended several times since, most recently in August 2003. Most significantly for the purposes of this Article, the House of Delegates approved comprehensive changes to Model Rule 5.5 (Unauthorized Practice of Law; Multijurisdictional Practice of Law) on August 12, 2002, as a result of the work of the ABA's Multijurisdictional Practice Commission. *Preface to the 2004 Edition* of MODEL RULES OF PROF'L CONDUCT, *available at* http://www.abanet.org/cpr/mrpc/preface.html (last visited Apr. 6, 2005) [hereinafter PREFACE]. The amendments to Model Rule 5.5 and the work of the Multijurisdictional Practice Commission are discussed *infra* Part VI.B.

164. *See* PROFESSIONAL RESPONSIBILITY STANDARDS, RULES & STATUTES 4 (John S. Dzienkowski abridged ed., 2003-04).

> Although the ABA's codes of conduct have been influential in shaping the law of professional responsibility, they only have force as a body of rules with its voluntary members. However, the various states and the federal courts have looked to the ABA versions as a basis for regulating lawyers within the jurisdiction. Thus, the ABA's codes have been used as the basis for state and federal codes.

Id.

165. MODEL RULE FOR THE LICENSING OF LEGAL CONSULTANTS (1993), *available at* http://www.abanet.org/cpr/mjp/201h.doc (last visited Feb. 21, 2005).

166. A comprehensive evaluation of the consistency of the Model Rules and the approach to cross-border practice expressed in the *Accountancy Disciplines* is well beyond the scope of this Article. Instead, the intent of this section is to suggest how the core values of the American legal profession, as embodied in the *Model Rules of Professional Conduct*, compare to the core values expressed above by the CBA, the FLSC, and the CCBE, see *supra* note 102 and accompanying text, and to suggest how the American legal profession's conceptions of its ethical responsibilities and regulatory horizons may be challenged by the GATS. Thus, although the goal of this section is comparatively modest, it does suggest that a wider inquiry into the consistency of the GATS and the *Model Rules of Professional Conduct* might yield enlightening results. *See generally* Terry, *supra* note 13, at 1075.

A. Core Values and the Model Rules of Professional Conduct

Perhaps the principal core value of the American legal profession is expressed in the first of the Model Rules, which addresses the duty of competent representation:[167]

> Model Rule 1.1. Competence
>
> "A lawyer shall provide competent representation to a client. Competent representation requires the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation."[168]

The assumption inherent in Model Rule 1.1 is that once a lawyer is admitted to practice in a particular jurisdiction she is competent to handle any type of legal problem.[169] Geoffrey Hazard and William Hodes have reported that this assumption of competence can be traced to the traditional view that a lawyer who has passed a state bar examination is presumed competent to practice law.[170] In fact, competence was not recognized as a matter of

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> One of the questions that I have not had time to examine is the effect of this [standstill] principle on the work of the ABA Ethics 2000 Commission [which proposed amendments to the Model Rules]. If the work of the Ethics 2000 Commission were adopted verbatim by a state regulator, I wonder whether any of the changes proposed by the ABA Ethics 2000 Commission might be considered "more restrictive" than the prior rule and might violate any of the agreements contained in the U.S. *Schedule of Specific Commitments*.

Id.

167. *See* Brand, *supra* note 6, at 1138-39. The author makes a strong argument that Model Rule 1.1 is the chief core value of the American legal profession:

> The placement of this Rule at the beginning of the Model Rules emphasizes the importance of the duty owed to the client. The focus of this duty indicates the fundamental importance of the interests of the client in the application of all the Model Rules. The further fact that this duty can rarely be waived by the client underscores its significance to the attorney-client relationship. Thus, by its very nature, *this Rule provides the fundamental test in the interpretation of every other Model Rule.* No other Rule should be interpreted in a manner that would result in devaluation of the duty of competence or of its goal of proper representation of the client, nor should any rule be interpreted in a manner that accepts any other goal (e.g., protection of the profession) over this one.

Id. (emphasis added).

168. MODEL RULES OF PROF'L CONDUCT R. 1.1 (2003).

169. *Id.* at cmt. 2

> A lawyer need not necessarily have special training or prior experience to handle legal problems of a type with which the lawyer is unfamiliar. A newly admitted lawyer can be as competent as a practitioner with long experience. Some important legal skills, such as the analysis of precedent, the evaluation of evidence and legal drafting, are required in all legal problems.

Id.

170. GEOFFREY C. HAZARD & W. WILLIAM HODES, THE LAW OF LAWYERING § 3.2 (3d ed. Supp. 2003) [hereinafter HAZARD & HODES].

professional responsibility until the adoption of Canon 6 of the 1970 ABA *Model Code of Professional Responsibility*.[171] Before 1970, lawyer competence was almost exclusively policed through civil legal malpractice actions.[172] Unfortunately, the assumption of lawyer competence has not always proven sound.[173]

The assumption of lawyer competence enshrined in Model Rule 1.1, however, traditionally contained an important geographical limitation. That is to say that while a lawyer has historically been deemed competent in the jurisdiction in which he is admitted to practice, in most other jurisdictions, he is treated as a non-lawyer.[174] This "assumption of *incompetence*" is not directly embodied in the Model Rules, but is instead sanctioned in Model Rule 5.5, which prohibits the unauthorized practice of law:

> Model Rule 5.5. Unauthorized Practice of Law
>
> "A lawyer shall not:
>
> (a) practice law in a jurisdiction where doing so violates the regulation of the legal profession in that jurisdiction; or
> (b) assist a person who is not a member of the bar in the performance of activity that constitutes the unauthorized practice of law."[175]

> In an era in which rules of discipline were rarely considered binding in any event the absence of a professional rule on competence could be traced to the unstated view than any lawyer who had successfully completed a bar examination and met other entrance criteria was, by definition, competent to practice law. Serious errors might be evidence of neglect or lack of diligence, but basic competence was assumed to be unassailable.

Id.

171. *Id. The Model Code of Professional Responsibility* was adopted by the ABA in 1969, and was superseded by the *Model Rules of Professional Conduct* in 1983. PREFACE, *supra* note 163.

172. HAZARD & HODES, *supra* note 170, at § 3.2.

173. *See, e.g.*, William H. Gates, *Lawyers' Malpractice: Some Recent Data About a Growing Problem*, 37 MERCER L. REV. 559, 562 (1986) (reporting that 43.8% of legal malpractice claims involve "substantive errors," such as failure to know or properly apply the law, inadequate investigation, planning error, and failure to know about a deadline).

174. HAZARD & HODES, *supra* note 170, at § 46.5 ("Legal restrictions in most jurisdictions treat lawyers who are licensed elsewhere almost as if they were lay persons for purposes of the 'unauthorized practice' rules.").

175. MODEL RULES OF PROF'L CONDUCT R. 5.5 (2001) [hereinafter MODEL RULES 2001]. Note that this is not the current version of Model Rule 5.5. The current version of Model Rule 5.5 incorporates the concept of temporary practice by out-of-state lawyers. *See infra* Part VI.B. However, because only sixteen states have adopted multi-jurisdictional practice rules at least similar to the current version of Model Rule 5.5, the version of Model Rule 5.5 cited here is the one in effect in most states. *See* ABA Commission on Multi Jurisdictional Practice, State Implementation of ABA Model Rule 5.5 (Multi-jurisdictional Practice of Law), *available at*

It is accurate to say that Model Rule 5.5 merely sanctions disparate treatment of in-state lawyers and out-of-state lawyers because states are free to define the unauthorized practice of law within their respective jurisdictions.[176] Whatever gloss states may give to their unauthorized practice of law prohibitions, the purpose is ostensibly consumer protection.[177] Thus, the goal of Model Rule 5.5 is consonant with the duty of competence in Model Rule 1.1.[178] Given this identity of purpose between the duty of competence and the unauthorized practice of law, it is not immediately clear why this duty is expressed as a geographical limitation in Model Rule 5.5.[179] One answer may lay in the beneficial trade restrictive effects that a broad definition of the unauthorized practice of law may have for the local bar.[180] Nevertheless, taking stock of a lawyer's competence in rendering legal advice, regardless of geographical location, may better reflect the reality of interstate practice and may better serve clients by respecting their choice of counsel, even in matters

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http://www.abanet.org/cpr/jclr/5_5_quick_guide.pdf (last modified March 17, 2005) (last visited April 14, 2005) (including Arizona, Arkansas, California, Colorado, Delaware, Georgia, Idaho, Indiana, Maryland, Nevada, New Jersey, North Carolina, North Dakota, Oregon, Pennsylvania, and South Dakota in the list of states that have adopted a multijurisdictional practice rule similar to Model Rule 5.5).

176. *See* MODEL RULES 2001, *supra* note 175, at R. 5.5 cmt. ("The definition of the practice of law is established by law and varies from one jurisdiction to another."). The varying state approaches to defining the unauthorized practice of law is beyond the scope of this Article. For a comprehensive treatment, see Carol A. Needham, *Multijurisdictional Practice Regulations Governing Attorneys Conducting a Transactional Practice*, 2003 U. ILL. L. REV. 1331 (2003).

177. *See* MODEL RULES 2001, *supra* note, at R. 5.5 cmt. (2001) ("Whatever the definition, limiting the practice of law to members of the bar protects the public against rendition of legal services by unqualified persons."); *see also* Benjamin Hoorn Barton, *Why Do We Regulate Lawyers? An Economic Analysis of the Justifications for Entry and Conduct Regulation*, 33 ARIZ. ST. L.J. 429, 435 (2001) (noting the classic justification for entry regulations as "the protection of unsuspecting consumers from incompetent practitioners"). Professor Barton also notes that, "[t]his justification actually involves two connected claims: the legal market is subject to serious information asymmetries, and incompetent practitioners can inflict irreversible or irremediable harms upon clients." Barton, *supra.*

178. Brand, *supra* note 6, at 1143. "Whatever the definition may be, the purpose behind preventing unauthorized practice is the protection of the client. Thus, the goal of Model Rule 5.5 is consonant with the duty of competence in Model Rule 1.1." *Id.*

179. *See id.* at 1150.

> If, as noted above, the focus of Model Rule 5.5 on the unauthorized practice of law is the same as that of Model Rule 1.1—the duty of competence owed to the client—then the concern should be whether the representation is competently rendered, regardless of *where* it is rendered. Particularly in an age of instantaneous real and virtual delivery of services from any point on the globe, any focus on *where* the lawyer delivers services is only likely to lead to irrelevant legal fictions applied for the purpose of determining *where* the electronic transmission of those services occurs.

Id.

180. *See* HAZARD & HODES, *supra* note 170, at § 46.3 ("But the prohibition against unauthorized practice also functions, at least in part, as a trade restriction that precludes nonlawyers from legal tasks, however routine.").

with multijurisdictional elements.[181] In fact, Model Rule 1.1 would seem to call for just such an individualized appraisal of lawyer competence.[182]

In the end, one is left with two assumptions about the competence of legal practitioners in the United States. On the one hand, lawyers admitted to practice in a particular jurisdiction are presumptively competent to practice any kind of law in that jurisdiction, but on the other hand, states are free to regard out-of-state lawyers as presumptively *incompetent* to practice within that state's jurisdiction without any inquiry into individual lawyers' particular skills. This regime thus permits states to erect per se barriers to foreign lawyers practicing in the United States no matter how tangential that practice might be to a state's legitimate interest in protecting its consumers. Moreover, a restrictive view of the unauthorized practice of law would seem to undercut the very efficacy of GATS disciplines to govern the legal services sector because state unauthorized practice restrictions are not "based on objective and transparent criteria, *such as competence and the ability to supply the service*,"[183] and would have to yield if effective cross-border practice is to become a reality.

Although the Model Rules' permissive view of state lawyer unauthorized practice regulations might be inconsistent with the regulatory regime envisioned in the *Accountancy Disciplines*, recent developments within the ABA suggest an evolving awareness of the importance of multijurisdictional practice in both national and international practice, which might suggest some grounds for compromise. These developments are considered in the next section.

B. Foreign Legal Consultants and Temporary Practice: Bifurcating the Imperatives of Lawyer Regulation

The most significant developments within the ABA in the area of multijurisdictional practice over the last several years were products of the Commission on Multijurisdictional Practice, or the "MJP" Commission. The

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181. *See In re* Estate of Waring, 221 A.2d 193, 197 (N.J. 1966).
> Multistate relationships are a common part of today's society and are to be dealt with in commonsense fashion. While the members of the general public are entitled to full protection against unlawful practitioners, their freedom of choice in the selection of their own counsel is to be highly regarded and not burdened by "technical restrictions which have no reasonable justification."

Id.

182. *See* MODEL RULES OF PROF'L CONDUCT R. 1.1 cmt. 1 (2003).
> In determining whether a lawyer employs the requisite knowledge and skill in a particular matter, relevant factors include the relative complexity and specialized nature of the matter, the lawyer's general experience, the lawyer's training and experience in the field in question, the preparation and study the lawyer is able to give the matter and whether it is feasible to refer the matter to, or associate or consult with, a lawyer of established competence in the field in question . . . .

Id.

183. GATS, *supra* note 8, at art. VI(4)(a) (emphasis added).

Commission was formed in July 2000,[184] with the mandate to report on the state of multijurisdictional practice in the United States and to make recommendations that would facilitate that practice in the public interest.[185] The MJP Commission ultimately made nine recommendations[186] to the ABA House of Delegates, which adopted all nine on August 12, 2002.[187] Three of these recommendations are relevant for the present purposes, including those relating to the Multijurisdictional Practice of Law (Recommendation 2), the Licensing of Legal Consultants (Recommendation 8), and the Temporary Practice of Foreign Lawyers (Recommendation 9).

Most significantly for the domestic practitioner, the MJP Commission's Recommendation 2 on the Multijurisdictional Practice of Law effected a significant change to Model Rule 5.5.[188] As discussed above,[189] Model Rule 5.5 prohibits a lawyer from practicing law in a jurisdiction where doing so would violate the regulation of the legal profession in that jurisdiction.[190] In addition to clarifying and strengthening the unauthorized practice prohibition in

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184. AM. BAR ASS'N, CTR. FOR PROF'L RESPONSIBILITY, CLIENT REPRESENTATION IN THE 21ST CENTURY: REPORT OF THE COMMISSION ON MULTIJURISDICTIONAL PRACTICE vii (2002) [hereinafter MJP Report].

185. Comm'n on Multijurisdictional Practice of Law, Mission Statement, *available at* http://www.abanet.org/cpr/mjp-mission_statement.html (last visited Feb. 25, 2005).

> RESOLVED that the American Bar Association establish the Commission on the Multijurisdictional Practice to research, study and report on the application of current ethics and bar admission rules to the multijurisdictional practice of law. The Commission shall analyze the impact of those rules on the practices of in-house counsel, transactional lawyers, litigators and arbitrators and on lawyers and law firms maintaining offices and practicing in multiple state and federal jurisdictions. The Commission shall make policy recommendations to govern the multijurisdictional practice of law that serve the public interest and take any other action as may be necessary to carry out its jurisdictional mandate. The Commission shall also review international issues related to multijurisdictional practice in the United States.

Id. For a comprehensive overview of the work of the Multijurisdictional Practice Commission, see Stephen Gillers, *Lessons from the Multijurisdictional Practice Commission: The Art of Making Change*, 44 ARIZ. L. REV. 685 (2002). Professor Gillers was a member of the Multijurisdictional Practice Commission.

186. *See* MJP Report, *supra* note 184, at 2-4. These recommendations addressed the following topics: Regulation of the Practice of Law by the Judiciary (Recommendation 1); Multijurisdictional Practice of Law (Recommendation 2); Disciplinary Authority (Recommendation 3); Reciprocal Discipline (Recommendation 4); Interstate Disciplinary Enforcement Mechanisms (Recommendation 5); *Pro Hac Vice* Admission (Recommendation 6); Admission by Motion (Recommendation 7); Licensing of Legal Consultants (Recommendation 8); Temporary Practice by Foreign Lawyers (Recommendation 9). *Id.*

187. Summary of Recommendations, American Bar Association House of Delegates, 2002 Annual Meeting, Washington D.C., Recommendations 201A-J, *available at* http://www.abanet.org/leadership/recommendations02/ summary.html (last visited Apr. 6, 2005) [hereinafter MJP Recommendations].

188. *See* MJP Report, *supra* note 184, at 19-34.

189. *See supra* note 175 and accompanying text.

190. *Id.*

Rule 5.5,[191] the amended rule would also provide certain "safe harbors" from charges of unauthorized practice of law for those practitioners engaged in legal work in more than one jurisdiction.[192] Amended Model Rule 5.5 has accordingly been re-titled to reflect its enhanced scope.[193]

Under amended Model Rule 5.5, an out-of-state lawyer may now practice with a local lawyer who is admitted to practice in that jurisdiction and who actively assists the out-of-state lawyer in pursuing the matter.[194] An out-of-state lawyer may also practice in a state where he has been admitted pro hac vice.[195]

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191. *See* MJP Report, *supra* note 184, at 24 ("Rule 5.5 would be clarified and strengthened by adoption of amended sections 5.5(a) and (b)."). Amended Rule 5.5(a) and (b) provides:

> (a) A lawyer shall not practice law in a jurisdiction in violation of the regulation of the legal profession in that jurisdiction, or assist another in doing so.
>
> (b) A lawyer who is not admitted to practice in this jurisdiction shall not:
>
> (1) except as authorized by these Rules or other law, establish an office or other systematic and continuous presence in this jurisdiction for the practice of law; or
>
> (2) hold out to the public or otherwise represent that the lawyer is admitted to practice law in this jurisdiction.

MODEL RULES OF PROF'L CONDUCT R. 5.5 (2003).

192. *See* MJP Report, *supra* note 184, at 24 n.33 (reporting the Commission's decision not to use the term "safe harbor" in the amended version of Rule 5.5, but noting that "the term . . . has been a useful metaphor for conceptualizing the categories of legal work that a lawyer admitted in one jurisdiction may do in another jurisdiction"). The approach of amended Model Rule 5.5 is consistent with the approach endorsed by RESTATEMENT (THIRD) LAW GOVERNING LAWYERS § 3 (2000), which states in relevant part:

> § 3. Jurisdictional Scope of the Practice of Law by a Lawyer
>
> A lawyer currently admitted to practice in a jurisdiction may provide legal services to a client: . . .
>
> (1) at a place within a jurisdiction in which the lawyer is not admitted to the extent that the lawyer's activities arise out of or are otherwise reasonably related to the lawyer's practice [in a jurisdiction in which he is admitted].

Id.

193. *See* MJP Report, *supra* note 184, at 23 ("The MJP Commission proposes to re-title the Rule "Unauthorized Practice of Law; Multijurisdictional Practice of Law."). The pre-2002 title of Model Rule 5.5 was simply "Unauthorized Practice of Law." *See supra* note 175 and accompanying text.

194. MODEL RULES OF PROF'L CONDUCT R. 5.5(c)(1) (2003).

> A lawyer admitted in another United States jurisdiction, and not disbarred or suspended from practice in any jurisdiction, may provide legal services on a temporary basis in this jurisdiction that: (1) are undertaken in association with a lawyer who is admitted to practice in this jurisdiction and who actively participates in the matter....

Id.

195. *Id.* at R. 5.5(c)(2) (". . . are in or reasonably related to a pending or potential proceeding before a tribunal in this or another jurisdiction, if the lawyer, or a person the lawyer is assisting, is authorized by law or order to appear in such proceeding or reasonably expects to be so authorized . . ."). "Admission *pro hac vice*" is the temporary admission of an out-of-state lawyer admitted to practice before a particular court in a specific case. *See* BLACK'S LAW DICTIONARY 49 (7th ed. 1999).

Moreover, in proceedings that do not require admission pro hac vice, an out-of-state lawyer may practice in the host jurisdiction if the services rendered are related to an arbitration or other alternative dispute resolution so long as those proceedings arise out of the lawyer's practice in a state in which she is admitted to practice.[196] Where the practice does not fall within the above exceptions, but nonetheless arises out of or is reasonably related to a lawyer's home-state practice, the out-of state lawyer may be admitted on a temporary basis.[197] Lastly, amended Model Rule 5.5 provides an exception for multijurisdictional practice by corporate counsel.[198]

Pursuant to its mandate,[199] the MJP Commission also took account of the barriers to multijurisdictional practice within the United States by foreign practitioners. To this end, the Commission proposed and the House of Delegates adopted Recommendation 8, urging states to enact the ABA *Model Rule for the Licensing of Legal Consultants*.[200] This Model Rule permits a foreign lawyer who meets the licensing criteria[201] to practice on a regular basis

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196. MODEL RULES OF PROF'L CONDUCT R. 5.5(c)(3).

> . . . are in or reasonably related to a pending or potential arbitration, mediation, or other alternative dispute resolution proceeding in this or another jurisdiction, if the services arise out of or are reasonably related to the lawyer's practice in a jurisdiction in which the lawyer is admitted to practice and are not services for which the forum requires *pro hac vice* admission . . . .

Id.

197. *Id.* at R. 5.5(c)(4) (" . . . are not within paragraphs (c)(2) or (c)(3) and arise out of or are reasonably related to the lawyer's practice in a jurisdiction in which the lawyer is admitted to practice"). On the content of the requirement that the matter in the host-state jurisdiction be "reasonably related" to the out-of-state lawyer's local practice, found in both subsection (c)(3) and (c)(4), see *Id.* at cmt. 14.

198. *Id.* at R. 5.5(d).

> A lawyer admitted in another United States jurisdiction, and not disbarred or suspended from practice in any jurisdiction, may provide legal services in this jurisdiction that: (1) are provided to the lawyer's employer or its organizational affiliates and are not services for which the forum requires pro hac vice admission; or (2) are services that the lawyer is authorized to provide by federal law or other law of this jurisdiction.

Id. For more on multijurisdictional practice issues facing corporate or "in-house" counsel, *see generally* Needham, *supra* note 176.

199. *See supra* note 185 and accompanying text.

200. MJP Recommendations, *supra* note 187, at 201 H ("RESOLVED, that the American Bar Association encourage jurisdictions to adopt the ABA Model Rule for the Licensing of Legal Consultants, dated August 1993.").

201. MODEL RULE FOR THE LICENSING OF LEGAL CONSULTANTS § 1 (General Regulation as to Licensing).

> In its discretion, the [name of court] may license to practice in this State as a legal consultant, without examination, an applicant who:
>
> (b) is a member in good standing of a recognized legal profession in a foreign country, the members of which are admitted to practice as attorneys or counselors at law or the equivalent and are subject to effective regulation by a duly constituted professional body or a public authority;
>
> (c) for at least five of the seven years immediately preceding his or her

within the host state without becoming a member of the state bar, but subject to certain limitations on her scope of practice.[202] The MJP Commission also

application has been a member in good standing of such legal profession and has actually been engaged in the practice of law in the said foreign country or elsewhere substantially involving or relating to the rendering of advice or the provision of legal services concerning the law of the said foreign country;

(d) possesses the good moral character and general fitness requisite for a member of the bar of this State;

(e) is at least twenty-six years of age; and

(f) intends to practice as a legal consultant in this State and to maintain an office in this State for that purpose.

Id.

202. *Id.* § 4 (Scope of Practice).

A person licensed to practice as a legal consultant under this Rule may render legal services in this State subject, however, to the limitations that he or she shall not:

(a) appear for a person other than himself or herself as attorney in any court, or before any magistrate or other judicial officer, in this State (other than upon admission *pro hac vice* pursuant to [citation of applicable rule]);

(b) prepare any instrument effecting the transfer or registration of title to real estate located in the United States of America;

(c) prepare:

i. any will or trust instrument effecting the disposition on death of any property located in the United States of America and owned by a resident thereof, or

ii. any instrument relating to the administration of a decedent's estate in the United States of America;

(d) prepare any instrument in respect of the marital or parental relations, rights or duties of a resident of the United States of America, or the custody or care of the children of such a resident;

(e) render professional legal advice on the law of this State or of the United States of America (whether rendered incident to the preparation of legal instruments or otherwise) except on the basis of advice from a person duly qualified and entitled (other than by virtue of having been licensed under this Rule) to render professional legal advice in this State;

(f) be, or in any way hold himself or herself out as a member of the bar of this State; or

(g) carry on his or her practice under, or utilize in connection with such practice, any name, title or designation other than one or more of the following:

i. his or her own name;

ii. the name of the law firm with which he or she is affiliated;

iii his or her authorized title in the foreign country of his or her admission to practice, which may be used in conjunction with the name of such country; and

iv. the title "legal consultant," which may be used in conjunction with the words "admitted to the practice of law in [name of the foreign country of his or her admission to practice]."

Id. Twenty-four states presently have some scheme for the licensing of foreign legal consultants. *See* MJP Report, *supra* note 184, at 61 n.54. For a comprehensive review of state

recognized the need for rules to permit foreign lawyers who may not practice regularly in the United States, and thus would not qualify for legal consultant status,[203] by recommending the enactment of the ABA *Model Rule for Temporary Practice by Foreign Lawyers*.[204] This Model Rule simply extends the "safe harbor" concept of amended Model Rule 5.5 to foreign legal practitioners.[205] In fact, some of the provisions of the Temporary Foreign Practice Rule are identical to language found in amended Model Rule 5.5.[206]

The upshot of this recent ABA activity is the significant erosion of the basic presumptions that were identified in Part A above. There, it was noted that the Model Rules originally seemed to begin with two basic notions of competence. They seemed to suggest, first, that lawyers admitted to practice in a particular jurisdiction were presumptively competent to practice in that jurisdiction, and second, that lawyers licensed elsewhere were presumptively *incompetent* to practice in that jurisdiction.[207] With the inclusion of the "safe harbor" or "temporary practice" concept in the 2002 amendments to Model Rule 5.5, which permits U.S. lawyers to temporarily practice in states where they are not admitted to the bar, the latter proposition no longer appears sound. It is one matter to permit U.S. lawyers to practice temporarily in other U.S. jurisdictions, but the ABA has gone even further by sanctioning the temporary practice of *foreign* lawyers in the United States pursuant to the *Model Rule for*

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approaches, see generally Carol A. Needham, *The Licensing of Foreign Legal Consultants in the United States*, 21 FORDHAM INT'L L.J. 1126 (1998).

203. MODEL RULE FOR THE LICENSING OF LEGAL CONSULTANTS § 1(e) ("intends to practice as a legal consultant in this State *and to maintain an office in this State for that purpose*") (emphasis added).

204. AM. BAR ASS'N COMM'N ON MULTIJURISDICTIONAL PRACTICE, REPORT TO THE HOUSE OF DELEGATES, MODEL RULE FOR TEMPORARY PRACTICE BY FOREIGN LAWYERS (2002) [hereinafter RULE FOR TEMPORARY PRACTICE BY FOREIGN LAWYERS], *reprinted in* MJP Report, *supra* note 184, at 67 (Recommendation 9).

205. *See* MJP Report, *supra* note 184, at 68.

> For example, a foreign lawyer who is negotiating a transaction on behalf of a client in the lawyer's own country may come to the United States briefly to meet other parties to the transaction and their lawyers or to review documents. Or a foreign lawyer conducting litigation in the lawyer's home country may come to the United States to meet witnesses. While it is not feasible for foreign lawyers in such circumstances to seek admission as foreign legal consultants, it should nevertheless be permissible for them to provide these temporary and limited services in the United States.

Id.

206. *Compare* RULE FOR TEMPORARY PRACTICE BY FOREIGN LAWYERS, *supra* note 204, at § (a)(1) *with* MODEL RULES OF PROF'L CONDUCT 5.5(c)(1) (2003).

> Such a lawyer does not engage in the unauthorized practice of law in this jurisdiction when on a temporary basis the lawyer performs services in this jurisdiction that: (1) *are undertaken in association with a lawyer who is admitted to practice in this jurisdiction and who actively participates in the matter.*

RULE FOR TEMPORARY PRACTICE BY FOREIGN LAWYERS, *supra* note 204, at § (a)(1) (emphasis added); *see also* MJP Report, *supra* note 184, at 68 (noting that "[t]his language is identical to language in [amended] Rule 5.5(c)(1) of the ABA *Model Rules of Professional Conduct* for lawyers admitted in a United States jurisdiction").

207. *See supra* Part VI.A.

Temporary Practice by Foreign Lawyers. Moreover, if a foreign lawyer meets the criteria of the *Model Rule for Licensing of Legal Consultants*, she may even be able to practice on a regular basis in a particular jurisdiction.

Another way to conceive of this evolving liberalization of domestic multijurisdictional practice is to see it as a shift away from a regulatory default to a more market-oriented approach. Whether this is a "good" thing or a "bad" thing might depend on our conception of the "baseline" of professional regulation.[208] Professor Benjamin Barton has suggested that even in the domestic context, a market-oriented approach to lawyer regulation is to be preferred. Professor Barton opines that "[u]tilizing the market as the baseline is preferable for two reasons. First, there has long been a general American preference for the free market over government regulation. Second, even the strongest modern defenders of regulation do not argue that regulation should replace the free market on the whole."[209] If the argument for a market-oriented policy with respect to domestic multijurisdictional practice is at least defensible, then certainly the argument for a market-oriented approach to transnational multijurisdictional practice questions is considerably stronger.

The demand for transnational practitioners comes mostly from multinational corporations, large banks, and other large, institutional clients who wish to retain lawyers with the relevant experience or expertise in specific kinds of transactions, regardless of nationality or formal qualifications in particular jurisdictions.[210] Furthermore, as a general matter, most clients who

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208. *See* Barton, *supra* note 177, at 432 n.11.

> Admittedly, this approach implicitly assumes that regulation of an occupation or an industry must be justified, which assumes non-regulation and the free market to be the status quo. By contrast, one might argue that the discussion should begin with justifications for not regulating lawyers, that is, assume that government regulation of an occupation is the norm, and any deviation from regulation must be defended.

Id.

209. *Id.* (citations omitted).

210. *Legal Services Background Note*, *supra* note 3, at ¶ 23.

> Most of the demand for legal services in the fields of business law and international law comes from businesses and organizations involved in international transactions. These institutional actors will look for the legal services provider who gives them guarantees as to its knowledge of the firm's activities and of the place of business as well as of the quality of the service it can deliver, regardless of its place of origin.

Id. *See also* Bernard L. Greer, Jr., *The EEC and the Trend Toward the Internationalisation of Legal Services: Some Observations*, 15 INT'L BUS. LAW. 383, 383 (1987).

> Increasingly, clients base the selection of their lawyers upon factors other than their formal qualifications to practise law and the license they hold. The reason these lawyers are engaged is simply that their clients have decided that they are the best qualified to provide specific legal services in a timely and cost-effective manner. They have been chosen not for their nationality, formal qualifications or

regularly engage the services of transnational practitioners are sophisticated enough to ensure the competence of their attorneys.[211] As one commentator has put it, "it is disingenuous to argue that strict qualifications are needed to protect the likes of Mitsubishi Bank and IBM, as the consumers of legal services, from incompetent lawyers."[212] Even if principles of consumer protection should trump market principles in the regulation of the legal profession in the domestic context, it seems fairly clear that few such consumer protection concerns are presented in transnational practice and thus fewer regulatory barriers should be erected to the cross-border provision of legal services in this arena.

Many of the "core values" arguments that have been lodged at the *Accountancy Disciplines* stem from the notion that the legal profession is an indivisible entity with a single regulatory model.[213] Nevertheless, the ABA has shown through its adoption of the amended Model Rule 5.5, and especially of its endorsement of the *Model Rule for Licensing of Legal Consultants* and the *Model Rule for Temporary Practice by Foreign Lawyers*, that it is possible to bifurcate the imperatives of lawyer regulation by creating two regulatory regimes: one to govern cross-border practitioners, in which market considerations are paramount, and one to govern local practitioners, in which consumer protection concerns hold sway.

Undoubtedly it might be difficult at the margins to identify the regulatory sphere in which a particular activity might fall, as certainly there are gray areas inherent in the "temporary practice" concept, but such a scheme is preferable to one in which all outsiders to a particular jurisdiction are presumptively incompetent to practice in that jurisdiction merely because he is not a member of the local bar. This bifurcation would help to resolve many of the intractable issues surrounding bar association assertions of "core values" by giving the lie

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> the jurisdiction in which they are licensed, but rather for their experience and expertise. There is no reason to believe that we will not see more of this in the future.

Id.

211. Richard L. Abel, *Transnational Law Practice*, 44 CASE W. RES. L. REV. 737, 751 (1994). "The consumers are large, multinational corporations or financial institutions, which dominate their lawyers rather than vice versa. Most have house counsel fully capable of evaluating the quality of legal services and reviewing bills. Their relations with lawyers are continuous rather than episodic, so that purchasers are experienced." *Id.*

212. John Haley, *The New Regulatory Regime for Foreign Lawyers in Japan: An Escape From Freedom*, 5 UCLA PAC. BASIN L.J. 1, 14 (1986).

213. *See, e.g.*, CCBE Response, *supra* note 102, at 7.

> The first comment is to stress that the phrase "limited to subjects relevant to the activities for which authorisation is sought" is capable of meaning only one thing in the legal profession. It is not believed that anywhere in the world are foreign lawyers able to acquire a host qualification or title (as opposed to an ability to practise under home title) which is limited to a particular area. *In other words, if a lawyer is going to requalify and acquire the host title, it is the whole of the host title of lawyer which is acquired on requalification, enabling the foreign lawyer to carry out all the activities of the host lawyer. There is no alternative, lesser activity which can be obtained.*

Id. (emphasis added); *see also supra* note 122 and accompanying text.

to the idea that both local and transnational practitioners are similarly situated. Thus, by adopting a dual regulatory structure, bar associations could give effect to the core values of the profession in the domestic sphere, while dismantling the barriers that currently exist to the effective delivery of cross-border legal services.

VII. CONCLUSION

This Article has explained the importance that the ongoing GATS "disciplines" negotiations may have for the future regulation of trade in legal services. Despite intense opposition from some national bar associations, there appears to be ample room for compromise on the central issue of the negotiations, namely, whether the *Accountancy Disciplines* could form the basis of multilateral disciplines in the legal services sector. Nevertheless, this Article has also suggested that reaching this common ground could be imperiled by national bar associations' criticisms of the *Accountancy Disciplines* as contrary to the "core values" of the legal profession. Labeling various bar norms as "core values" effectively takes these policy choices out of the realm of compromise and may be used to foreclose agreement on issues that are crucial to reaching a successful resolution of the negotiations. These arguments are most accurately seen as efforts by national bar regulators to retain their traditional monopoly over prescribing the means as well as the ends of legal practice in their respective jurisdictions. This Article has also suggested that recent efforts within the American Bar Association to adopt alternative regulatory structures that recognize temporary practice rights in foreign practitioners, while maintaining traditional domestic lawyer regulations, could provide a basis for compromise in the WPDR negotiations.

It is hoped that by seeing "core values" arguments for what they frequently are, assertions of regulatory prerogatives by national authorities, the negotiators in Geneva can move beyond rhetorical posturing and squarely address the real and difficult issues involved in regulating the international trade in legal services.

MULTILATERAL FAILURE: A COMPREHENSIVE ANALYSIS OF THE SHRIMP/TURTLE DECISION

Marc Rietvelt*

I. INTRODUCTION

In the mid-1980s, renowned biologist Edmund O. Wilson infamously opined that the continued loss or reduction of biological diversity in our ecosystems would result in a more egregious impact on the state of our current world than energy depletion, economic collapse, limited nuclear war, or even conquest by a totalitarian government.[1] In explaining this shocking assertion, Wilson pointed to the fact that, while certainly catastrophic on many levels, the international community could still rebound from the damaging effects of these events within a few generations.[2] In contrast, declared Wilson, the derelict and apathetic extinction of species "is the folly [for which] our descendants are least likely to forgive us."[3]

Since Wilson uttered these foreboding words nearly twenty years ago, the world has lost between 540,000 and 3,000,000 different species of plant and animal life.[4] This astonishing appraisement is only compounded by the international community's lack of unity toward tempering environmental destruction, as well as effectuating environmental protection. While there is an urgent need for national, international, and local measures to conserve and protect species and ecosystems, the body of both national and international law that has emerged to date has been both diffuse and too narrow in scope.[5]

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* Marc Rietvelt, Briefing Attorney to the Hon. Karen Angelini, Fourth Court of Appeals, San Antonio, Texas, 2004-2005. B.A., Abilene Christian University; M.B.A., Texas Tech University; J.D., Texas Tech University School of Law. Special thanks to Professor Gabriel Eckstein of Texas Tech University School of Law, without whose advice, suggestions, and support, none of this would have been possible.

1. ROBERT GOODLAND ET AT., ENVIRONMENTAL MANAGEMENT IN TROPICAL AGRICULTURE 207 (1984) (quoting Edmund O. Wilson).

2. *Id.*

3. *Id.*

4. Environmental commentator Virginia Dailey estimates that the "world is losing between 27,000 and 150,000 species per year, approximately seventy-four species every day, and an astonishing three species every hour." Virginia Dailey, *Sustainable Development: Reevaluating the Trade vs. Turtles Conflict at the WTO*, 9 TRANSNAT'L L. & POL'Y 331, 332 (2000).

5. Edith Brown Weiss & John H. Jackson, *The Framework for Environment and Trade Disputes, in* RECONCILING ENVIRONMENT AND TRADE 1-2 (Edith Brown Weiss & John H. Jackson eds., 2001). *See, e.g.*, The Convention on International Trade in Endangered Species of Wild Fauna and Flora, March 3, 1973, app. I, 27 U.S.T. 1087, 1118; 993 U.N.T.S. 243, 257 [hereinafter CITES]. CITES prohibits commercial trade in species threatened with extinction

In response to this growing environmental crisis, the United States enacted legislation aimed at protecting the environment and environmental resources.[6] By utilizing trade regulation as its primary vehicle of motivation toward compliance, however, the effects of this new legislation soon created ripples felt across borders.[7] These events have led to tremendous discord in the international community and courts alike. Yet, to date, all such environmental laws have been challenged internationally before, and subsequently denied by, the trade authorities under the General Agreement on Tariffs and Trade (GATT).[8]

Is the United States wrong to seek international environmental goals through unilateral measures? In the post-World War II era, both sides can probably appreciate the concern for and preference against such policy.[9] Therefore, the more salient question is: Why did the United States feel it had to act in such a way, and in its alternative, how should the country plan to act in the future?

In addressing these and related issues, this Article focuses on the recent World Trade Organization (WTO) case *United States—Import Prohibition of Certain Shrimp and Shrimp Products*,[10] a landmark decision that also marks perhaps one of the most complicated and convoluted legal analyses ever rendered. While the *Shrimp/Turtle* decision is not lacking for criticism and commentary from the environmental and trade communities, most legal comments thus far have exhaustively focused on the perceived overbroad, or depending on one's point of view, overly narrow, and substantively incorrect

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and controls trade in those whose survival could be threatened if trade in them were not controlled. The Convention, however, only controls trade in those species that countries have agreed to list, and only in countries that are party to the Convention. *Id.*

6. Departments of Commerce, Justice, and State, the Judiciary, and Related Agencies Appropriations Act of 1990, Pub. L. No. 101-162, § 609, 103 Stat. 988, 1037-38 (codified as Endangered Species Act of 1973, 16 U.S.C. § 1537 (1994)). *See generally* Dailey, *supra* note 4, at 332.

7. *Id.*

8. *See* Dailey, *supra* note 4, at 333.

9. In 1929, there was a severe worldwide depression. In response, the United States enacted the 1930 Smoot Hawley Tariff Act, which provided for the raising of national tariffs. This legislation also served as a form of retaliation for the imposition of rising tariffs by other nations. After World War II, the United States and other involved nations:

> [L]ooked back at the period between 1920 and 1940 and realized that they had made serious mistakes in their economic policies, which were a major cause of the disasters that led to the War . . . . These included the policies leading to the Great Depression, the harsh reparations policy towards Germany following World War I, and the many protectionist measures that States took which choked off international trade.

Weiss & Jackson, *supra* note 5, at 4. Consequentially, "in December 1945, the same year the United Nations was established, the United States invited other countries to enter into negotiations for a multilateral agreement to mutually reduce tariffs." *Id.*

10. Report of the Appellate Body, *United States—Import Prohibition of Certain Shrimp and Shrimp Products*, WT/DS58/AB/R (Oct. 12, 1998), *available at* http://www.wto.org/english/tratop_e/dispu_e/distabase_e.htm [hereinafter *Shrimp/Turtle*].

interpretation of the WTO's Article XX Chapeau.[11] Such comments are narrow-sighted and myopic in overall goals and ambition. The WTO, as the original drafter and facilitator, will interpret their international trade rules as they have intended and see fit. Therefore, perhaps a more important argument would be that the WTO, as an arbiter of international law and jurisdiction, failed to properly heed pertinent authority and customary international law in deciding *Shrimp/Turtle* and other decisions.

This Article contends that there must be an affirmation that trade-related environmental measures authorized under internationally recognized environmental principles and customary law are consistent with WTO rules. In particular, the application of sustainable development as a legal concept was conveniently ignored in the Appellate Body's *Shrimp/Turtle* ruling. Such "oversights" have evidenced the need for a more neutral forum and arbiter of international trade-environment issues. Part II outlines the plight of sea turtles in the world, paying specific attention to the remedial measures utilized by the U.S. under Section 609. Part III discusses the *Shrimp/Turtle* decision and the grounds for the Appellate Body's controversial ruling. Part IV attends to the concerns of the international trade community and possible arguments for why, while confusing and contradictory, the Appellate Body may have come to the right conclusion. Finally, Part IV concludes with a discussion of why unilateral measures may in fact be necessary in some instances and why critics have failed in their lack of discussion of international law and principles. Part IV will call for a more neutral arbiter of future trade-environment cases.

II. THE SEA TURTLE DILEMMA

"Despite its smooth, elegant motion under water, the sea turtle has created a tremendous wake in the realms of environmental protection and free trade."[12] The conflict underlying the *Shrimp/Turtle* case concerns a 1989 amendment to the United States Endangered Species Act of 1973 and the so-called Section 609 that generally prohibit the importation of shrimp and shrimp products where harvesting methods are or can be employed that do not sufficiently protect the sea turtles.[13] Discussed in more detail later, Section 609 generally provides that the importation ban will not apply to harvesting countries that are

11. *See* Marlo Pfister Cadeddu, *Turtles in the Soup? An Analysis of the GATT Challenge to the United States Endangered Species Act Section 609 Shrimp Harvesting Nation Certification Program for the Conservation of Sea Turtles*, 11 GEO INT'L ENVTL. L. REV. 179 (1998).

12. Jackson F. Morrill, *A Need for Compliance: The Shrimp Turtle Case and the Conflict Between the WTO and the United States Court of International Trade*, 8 TUL. J. INT'L & COMP. L. 413, 413 (2000).

13. Axel Bree, *Article XX GATT—Quo Vadis? The Environmental Exception After the Shrimp/Turtle Appellate Body Report*, 17 DICK J. INT'L L. 99 (1998).

certified by the U.S. government.[14] Certification, however, will only be granted to "either those countries with a fishing environment that does not pose a threat of incidentally taking sea turtles or to those harvesting nations that adopt a regulatory program that is comparable to or as effective as the regulatory program of the United States."[15] In particular, the U.S. domestic program mandates the use of turtle excluder devices (TEDs), which in the actual application of the regulation became the de facto standard requirement for granting certification.[16] In 1996, the countries of India, Malaysia, and Thailand filed their first complaint with the WTO, pleading that the legislation be overturned as indicative of unfair trade practices.[17] The battle lines had been firmly drawn.

A. Factual Background

"Found in most warm water ocean environments of the world, sea turtles are long-lived air-breathing marine reptiles."[18] As adults, sea turtles spend most of their lives at sea, only venturing to come ashore when females in each population periodically beach to lay their eggs.[19] As a result, despite their amicable appearances and relatively widespread appeal, very little is known about sea turtles.

1. Sea Turtles and Shrimp Trawling

In sharp contrast, "[t]he facts about sea turtles killed by shrimp trawling are well documented and generally uncontested."[20] Shrimp trawling is practiced extensively in the tropical and subtropical coastal habitats frequented by sea turtles.[21] Typically, the trawls are submerged long enough that most turtles incidentally caught in the nets will drown.[22]

Indeed, shrimp trawling is largely recognized as the most wasteful commercial fishery in the world.[23] "In the Gulf of Mexico alone, shrimpers kill and waste approximately 2.5 billion pounds of fish a year, of which 70 percent would have been commercially valuable upon further maturation."[24] Chief

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14. Departments of Commerce, Justice, and State, the Judiciary, and Related Agencies Appropriations Act § 609.

15. Bree, *supra* note 13, at 105.

16. *Id.*

17. *Id.*

18. Sanford Gaines, *The WTO's Reading of the GATT Article XX Chapeau: A Disguised Restriction on Environmental Measures*, 22 U. PA. J. INT'L ECON. L. 739, 760 (2001).

19. *Id.*

20. Lakshman Guruswamy, *The Annihilation of Sea Turtles: World Trade Organization Intransigence and U.S. Equivocation*, 30 ENVTL. L. REP. 10261 (2000).

21. Gaines, *supra* note 18, at 762.

22. *Id.*

23. Guruswamy, *supra* note 20.

24. *Id.*

among the superfluous by-catch are sea turtles, with the estimated annual loss worldwide approaching a staggering 150,000 turtles.[25] As migratory creatures, sea turtles occupy an important role in the biodiversity of the ocean, and they have even been characterized as an indicator species.[26] Therefore, their mortality represents a grave and present danger to many different ecosystems.[27]

The sea turtles' destruction has certainly not gone without notice. Internationally, all species of sea turtles are listed in Appendix I, the most protective listing under the Convention on International Trade in Endangered Species (CITES).[28] Additionally, six multinational species are listed in the Convention on Migratory Species of Wild Animals[29] and all seven species are on the International Union for the Conservation of Nature (IUCN) Red List.[30] Nationally, most countries have enacted endangered species legislation that protects the animals.[31] The five species present in the waters of the United States, for example, are listed as endangered or threatened under the

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25. Bret Puls, Note, *The Murky Waters of International Environmental Jurisprudence: A Critique of Recent WTO Holdings in the Shrimp/Turtle Controversy*, 8 MINN J. GLOBAL TRADE 343, 346 (1999).

26. Guruswamy, *supra* note 20. Indicator species provide a unique and helpful analysis of the biological condition in an ecosystem. "While indicator species is a term that is often used, it is somewhat inaccurate. Indicators are actually groups or types of biological resources that can be used to assess environmental condition." *Id.* Nevertheless, the consistent monitoring of indicator species has proven to be an invaluable tool for the international community. It has often been used as an early warning of pollution or degradation in an ecosystem, as well as a sign of negative environmental trends. U.S. ENVTL. PROT. AGENCY, BIOLOGICAL INDICATORS OF WATERSHED HEALTH, *at* http://www.epa.gov/bioindicators/html/indicator.html (last updated Feb. 15, 2005).

27. *Id.*

28. *See* CITES, *supra* note 5.

29. Bonn Convention on the Conservation of Migratory Species of Wild Animals, Nov. 1, 1979, 19 I.L.M. 15 (entered into force Nov. 1, 1983).

30. *See* A. B. Meylan & P. A. Meylan, *Introduction to the Evolution, Life History, and Biology of Sea Turtles*, *in* IUCN/SSC Marine Turtle Specialist Group Publication No. 4, Research and Management Techniques for the Conservation of Sea Turtles 3 (K. L. Eckert et al. eds., 1999). IUCN, through its Species Survival Commission (SSC), has for four decades been assessing the conservation status of species, subspecies, varieties and even selected subpopulations on a global scale in order to highlight taxa threatened with extinction, and therefore promote their conservation. The IUCN Red List of Threatened Species provides taxonomic, conservation status and distribution information on taxa that have been evaluated using the IUCN Red List categories and criteria. The main purpose of the IUCN Red List is to catalogue and highlight those taxa that are facing a higher risk of global extinction (i.e., those listed as Critically Endangered, Endangered and Vulnerable). However, the IUCN Red List also includes information on taxa that are categorized as Extinct or Extinct in the Wild, on taxa that cannot be evaluated because of insufficient information (i.e., are Data Deficient), and on taxa that are either close to meeting the threatened thresholds or would be threatened were it not for an ongoing taxon-specific conservation program (i.e., Near Threatened). International Union for the Conservation of Nature and Natural Resources, 2004 IUCN Red List of Endangered Species, *at* http://www.redlist.org (n.d.) (last visited Apr. 3, 2005).

31. Hannah Gillelan, *Considering the Biology of the Sea Turtles in the WTO Dispute Settlement Process*, *in* RECONCILING ENVIRONMENT AND TRADE 477 (Edith Brown Weiss & John H. Jackson eds., 2001).

Endangered Species Act.[32] Despite all of the efforts, though, at least five species of sea turtles are in imminent danger of extinction, largely due to the continued practices of the shrimping industry.[33]

2. The United States Responds

Concerned by the decline in the sea turtle population due to shrimp trawling, in 1981, Congress instructed the National Marine Fisheries Service (NMFS) to begin an extensive research project to develop alternative methods of shrimp trawling that would not dramatically increase the cost to shrimpers while still protecting the sea turtles.[34] This research culminated in the development of the Turtle Excluder Device (TED). The TED is a metal grid of bars attached to a shrimp trawling net. It has an opening at either the top or the bottom, which creates a hatch allowing sea turtles and other large animals incidentally caught in the nets to escape while keeping the shrimp inside.[35] However, despite their efforts to distribute TEDs to shrimp fishermen and to instruct them how to properly employ the devices, the NMFS was unable to induce enough fishermen to voluntarily use the TEDs to significantly affect the turtle mortality rates due to concerns over a reduction in the catch.[36]

Therefore, in response to the NMFS's failed attempt to induce shrimpers to voluntarily adopt the use of TEDs, the U.S. Department of Commerce initiated a series of steps designed to increase compliance. First, it imposed strict regulations on the United States domestic shrimp fleet, eventually mandating the use of TEDs.[37] Soon after, motivated largely out of concern that the new requirements would weaken their competitive position vis-à-vis shrimpers from countries not using TEDs, American shrimpers protested vehemently against the TED regulation.[38] At the same time, because of the turtles' migratory nature, "sea turtle experts and environmentalists warned that the United States measures [would], by themselves, [prove] insufficient to

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32. Departments of Commerce, Justice, and State, the Judiciary, and Related Agencies Appropriations Act § 609.

33. Puls, *supra* note 25, at 346 (quoting a recent statement signed by more than 160 scientists from twenty-four different nations). In addition, according to John McCosker, the Chairman of the Aquatic Biology Department at California Academy of Science, "each species of sea turtles protected under United States law faces a very high risk of extinction in the wild." Dailey, *supra* note 4, at 333.

34. Renata Benedini, *Complying with the WTO Shrimp-Turtle Decision*, *in* RECONCILING ENVIRONMENT AND TRADE 409-415 (Edith Brown Weiss & John H. Jackson eds., 2001). "TEDs, costing between $50 and $400, provide 'a simple, inexpensive solution' that may reduce turtle casualties by at least 97 percent." Puls, *supra* note 25, at 346 (citation omitted).

35. Benedini, *supra* note 34, at 415. "Testing of the first TED concluded in late 1980." The final product, when employed in tests, was shown to "successfully exclude 97 percent of the sea turtles entering trawl nets." Cadeddu, *supra* note 11, at 184. In addition, the TED "also reduced bycatch by some 78 percent during the day and 50 percent at night." *Id.*

36. *Id.*

37. Gaines, *supra* note 18, at 762-63.

38. *Id.* at 763.

arrest sea turtle population decline around the world."[39] As a result, the commercial and environmental interests at home converged to support Congress' enactment in 1989 of Section 609 of the U.S. Endangered Species Act, a provision with extraterritorial reach that would become known as the Sea Turtle Act.[40]

B. Section 609

1. A "Carrot" and a "Stick"

Section 609 was drafted to contain a "carrot" and a "stick" that would together serve to extend sea turtle protection beyond the limited confines of U.S. waters and its exclusive economic zone.[41] As Sanford Gaines of the University of Pennsylvania explains:

> The carrot, Section 609(a), calls upon the departments of state and commerce to initiate negotiation of agreements with other countries "for the protection and conservation of sea turtles," specifically including all governments with jurisdiction over commercial fishing operations that "may affect adversely such species of sea turtles." The stick comes in Section 609(b), which prohibits, after May 1, 1991, the import of wild-caught shrimp "which have been harvested with commercial fishing technology which may affect adversely such species of sea turtles."[42]

In a controversial twist, however, Section 609 allowed for an exception to the importation ban alluded to in 609(b). Exporting nations were deemed to be exempted from the prohibition of 609(b) if "certified" by the President based on "documentary evidence of the adoption of a regulatory program governing the incidental taking of such sea turtles in the course of such harvesting that is comparable to that of the United States" and an average rate of incidental take of turtles comparable to the U.S. average.[43] Congress otherwise implemented a unilateral ban on the importation of shrimp products from non-complying countries.[44]

Section 609(b) clearly provided for more aggressive efforts to prevent the sea turtle's potentially imminent extinction. Thus, "[t]he unilateral trade ban

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39. *Id.*

40. § 609 103 Stat. at 1037-38.

41. Gaines, *supra* note 18, at 763.

42. *Id.* at 763-64.

43. Departments of Commerce, Justice, and State, the Judiciary, and Related Agencies Appropriations Act § 609; *see generally* Gaines, *supra* note 18 (discussing the statutory analysis in detail).

44. Morrill, *supra* note 12, at 417.

measures adopted by Congress in Section 609(b) served as the catalyst for both national and international litigation."[45]

2. The Proper Scope of Section 609

Over the next decade, several different sets of guidelines were introduced to feel out and properly implement the turtle protection legislation.[46] In 1991 and 1993, the first two sets of guidelines issued by the State Department were promulgated under Section 609.[47] These guidelines included two major provisions. First, in addressing the comparability of foreign regulatory programs, the guidelines mandated the use of TEDs on all shrimping vessels where there was a likelihood of intercepting sea turtles.[48] The only exceptions applied to vessels less than twenty-five feet in length, which were allowed to comply by reducing towing times.[49] Secondly, the State Department determined that Congress intended that the scope of Section 609 be limited in application to the Caribbean and western Atlantic region.[50]

Although the scope of the guidelines was expanded to affect the trawling practices of fishermen both domestically and abroad, according to some environmental groups, its limited Caribbean/western Atlantic application still ran contrary to the ESA's goal of protecting sea turtles.[51] In 1995, environmental NGOs challenged before the U.S. Court of International Trade (CIT) the decision of the State Department to limit the statute's coverage.[52] The CIT held that the prior guidelines were not a proper enforcement of Section 609.[53] The Court further directed the State Department to summarily prohibit the import of shrimp from *any* country in the world utilizing commercial shrimping practices that endanger those protected species of sea turtles.[54] In 1996, in response to the CIT's decision, the State Department made sweeping changes to the guidelines, and extended the import ban on shrimp and shrimp products throughout the world.[55]

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45. *Id.* at 418.

46. *See* Dailey, *supra* note 4, at 363.

47. *Id.*

48. *Id.*

49. *Id.* The guidelines also prohibited the retention of any incidentally caught sea turtles, and they required the resuscitation of any such turtles that were unconscious at the time of retrieval. *Id.*

50. *Id.*

51. Benedini, *supra* note 34, at 416.

52. *See* Earth Island Inst. v. Christopher, 942 F. Supp. 597 (Ct. Int'l Trade 1996), *vacated on other grounds*, Earth Island Inst. v. Albright, 147 F.3d 1352 (Fed. Cir. 1998).

53. *Christopher*, 942 F.Supp. at 599; *see* Dailey, *supra* note 4, at 364.

54. *Christopher*, 942 F.Supp. at 599; *see* Dailey, *supra* note 4, at 364.

55. Dailey, *supra* note 4, at 364.

3. Article XX Exceptions

While such trade restrictions are generally deemed unacceptable under GATT,[56] the "stick" of Section 609(b) was thought to fall under the environmental exceptions of Article XX. The relevant text of Article XX is brief and worth setting forth in full:

> Subject to the requirement that such measures are not applied in a manner which would constitute a means or arbitrary or unjustifiable discrimination between countries where the same conditions prevail, or a disguised restriction on international trade, nothing in this Agreement shall be construed to prevent the adoption or enforcement by any Member of measures: . . .
>
> (b) necessary for the protection of human, animal, or plant life or health; . . . [or]
>
> (g) relating to the conservation of exhaustible natural resources if such measures are made effective in conjunction with restrictions on domestic production or consumption; . . . .[57]

Article XX thus offers general exceptions from international trade obligations for trade measures employed in the pursuit of certain specified goals or purposes.[58]

However, several countries (specifically India, Malaysia, Pakistan, and Thailand) did not view the United States' actions or goals as particularly laudable, and on October 8, 1996, following the decision of the Court of International Trade and the revised 1996 guidelines, the complainants made a formal request for consultations through the WTO.[59] The complainants alleged that the U.S. restrictions on the importation of shrimp violated Articles I:1, XI:1, and XIII:1 of GATT 1994. In addition, the complainants argued that Section 609 did not qualify under the exceptions of Article XX(b) or XX(g). On February 25, 1997, the WTO Dispute Settlement Body referred the matter to a dispute settlement panel, and the battle was officially underway.[60]

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56. *Compare* GATT Dispute Panel Report on U.S.Restrictions on Imports of Tuna, Sept. 3, 1991, GATT B.I.S.D. (39th Supp.) at 1623 (1991) (explaining that such environmentally based trade measures might open the door to "green" protectionism), *with* GATT Dispute Panel Report on U.S. Restrictions on Import of Tuna, June 16, 1994, 33 I.L.M. 839 (1994) (reaffirming the earlier panel's ruling, but basing its decision on somewhat different grounds).

57. General Agreement on Tariffs and Trade, Article XX, Oct. 30, 1947, 61 Stat. A-11, T.I.A.S. 1700, 55 U.N.T.S. 194 [hereinafter GATT].

58. *See* generally Gaines, supra note 18, at 740.

59. *Id.* at 768.

60. *Id.*

III. THE *SHRIMP/TURTLE* DECISION

A. *The Panel Report*

In the *Shrimp/Turtle* dispute, the complainant countries were clearly annoyed by the perception that U.S. certification regulations were being used to strong-arm other nations' domestic policies. In particular, the Asian delegations addressed the concern that Section 609 was arbitrary and that countries should not be allowed to impose unilateral measures affecting trade regardless of the environmental grounds.[61] On April 6, 1998, the complainants' desires came to fruition.[62] On that date, the WTO dispute panel issued its final report, holding that the importation ban imposed by the United States under Section 609 could not be justified and, in fact, operated as a restriction on trade prohibited by that article.[63]

Succinctly stated, the panel ultimately examined the measure with regard to the chapeau of Article XX, which prohibits application of measures that would constitute "arbitrary or unjustifiable discrimination between countries where the same conditions prevail."[64] Believing that the exceptions in Article XX were limited and conditional, the panel found that Section 609 did indeed violate the chapeau of Article XX, and therefore found no need to address whether the measure fell under any of the exceptions.[65] On July 13, 1998, the

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61. Puls, *supra* note 25, at 356.

62. *Shrimp/Turtle*, *supra* note 10, at para. 112. The Appellate Body paraphrased and further cast light upon the panel's reading of the chapeau:

> [I]f an interpretation of the chapeau of Article XX were to be followed which would allow a Member to adopt measures conditioning access to its market for a given product upon the adoption by exporting Members of certain policies, including conservation policies, GATT 1994 and the WTO Agreement could no longer serve as a multilateral framework for trade among Members as security and predictability of trade relations under those Agreements would be threatened. This follows because, if one WTO Member were allowed to adopt such measures, then other Members would also have the right to adopt similar measures on the same subject but with differing, or even conflicting, requirements.

Id. "Indeed, as each of these requirements would necessitate the adoption of a policy applicable not only to export production . . . but also domestic production, it would be impossible for a country to adopt one of those policies without the risk of breaching other Members' conflicting policy requirements for the same product and being refused access to these other markets." *Id.*

63. *Id.* The panel determined that because Section 609 banned the importation of shrimp and shrimp products from any country not meeting the United States's rigid criteria, it constituted an impermissible "prohibition or restriction" under Article XI:1. The panel failed to see the need to address the WTO complainants' arguments that Section 609 also violated Articles I:1 and XIII:1 since it had already found that it violated Article XI:1. Benedini, *supra* note 34, at 447.

64. *Shrimp/Turtle*, *supra* note 10.

65. *See* Benedini, *supra* note 34, at 447.

United States notified the WTO of its decision to appeal certain issues of law and legal interpretations in the Panel Report.[66]

B. The Appellate Body's Report

In its first report following its establishment as an arbiter of international trade law under the Uruguay Round negotiations, the World Trade Organization Appellate Body rather simplistically concluded:

> WTO Members have a large measure of autonomy to determine their own policies on the environment (including its relationship with trade), their environmental objectives and the environmental legislation they enact and implement. So far as concerns the WTO, that autonomy is circumscribed only by the need to respect the requirements of the General Agreement and the other covered agreements.[67]

Two-and-a-half years and one U.S. appeal later, the Appellate Body issued its most complex and comprehensive decision considering the parameters of trade-disrupting environmental measures, the *Shrimp/Turtle* report.[68] Following the Appellate Body's decision, however, there still remains

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66. *See Shrimp/Turtle*, *supra* note 10, at para. 8.

67. Report of the Appellate Body, *United States—Standards for Reformulated and Conventional Gasoline,* WT/DS2/AB/R, at 19 (Apr. 29, 1996), *cited in* Paul O'Brien, *Unilateral Environmental Measures After the WTO Appellate Body's Shrimp-Turtle* Decision, in RECONCILING ENVIRONMENT AND TRADE 267 (Edith Brown Weiss & John H. Jackson eds., 2001).

68. *Shrimp/Turtle*, *supra* note 10. The *Shrimp/Turtle* dispute was not the first case under the WTO/GATT dispute settlement system concerning the validity of environmental measures, however. In *Tuna/Dolphin I*, the Body held that extraterritorial enforcement of any regulation is contrary to GATT policies, regardless of whether or not falling under any of the Article XX exceptions. GATT Dispute Panel Report on United States—Restrictions on Imports of Tuna, Sept. 3, 1991, GATT B.I.S.D. (39th Supp.) at 144 (1993). "Ignoring the text of the GATT treaty, the panel based its decision on an intuition that trade measures to protect the environment might somehow open the door to 'green' protectionism." Robert Howse, *The Appellate Body Rulings in the Shrimp/Turtle Case: A New Legal Baseline for the Trade and Environment Debate*, 27 COLUM. J. ENVTL. L. 491, 493 (2002). In *Tuna/Dolphin II*, the WTO backed off from its somewhat rigid stance, however, by reopening the possibility that countries may enforce environmental regulations abroad, but only if doing so will not infringe upon the sovereignty of other member countries. GATT Dispute Panel Report on United StatesRestrictions on Import of Tuna, 33 I.L.M. 839 (1994). Widely criticized, the *Tuna/Dolphin* rulings were never adopted as legally-binding dispute settlements by GATT's membership. As Robert Howse explains:

> Before the *Tuna/Dolphin* rulings, the prevailing view was that Article XX of the GATT decided any conflicts between free-trade rules and environmental norms in favor of the latter. The *Tuna/Dolphin* panels tried to switch the preference in favor of the latter. Worse still, they approached the question solely from the perspective of effects on liberalized trade. Traditionally, the GATT demonstrated respect for regulatory diversity and progressive government. But after *Tuna/Dolphin*, environmentalists—and others with concerns about how the

no clear or defined guidance concerning the autonomy of WTO members to act unilaterally with regard to environmentally protective measures.

1. Procedural Overview of the Appellate Body Report

Initially, the Appellate Body established the proper sequence for carrying out an analysis under Article XX. In contrast to the Panel's "chapeau-down" approach, the Appellate Body held that the structure and logic of Article XX analysis requires an initial determination of whether or not the violating measure qualifies under one of the specific exceptions in Article XX(a) through (j).[69] Only then can the application of the broad language of the chapeau be used to strike down the measure.[70] Therefore, the *Shrimp/Turtle* case posed for the WTO the fundamental question of how the general exceptions, as articulated under Article XX, qualify for and fit into the overall purposes of a multilateral trading system.

2. Substantive Analysis

a. Article XX(g)

Having determined that the Panel's "chapeau-down" approach was incorrect, the Appellate Body subsequently considered, per the agreement of the parties, whether Section 609 was justified under any of the exceptions of

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> trading system balances competing values—saw the GATT as a regime dedicated to the triumph of free trade over all other human concerns.

Robert Howse, *The Appellate Body Rulings in the* Shrimp/Turtle *Case: A New Legal Baseline for the Trade and Environment Debate*, 27 COLUM. J. ENVTL. L. 491, 493-94 (2002). Furthermore, the later panel decision in *Reformulated Gasoline* voiced approval for certain allowed environmental trade measures, but still looked unfavorably upon the unilateral nature of the particular challenged measure. Report of the Appellate Body, *United States—Standards for Reformulated and Conventional Gasoline*, WT/DS2/AB/R (Apr. 29, 1996), *available at* http://www.wto.org/english/tratop_e/dispu_e/distabase_e.htm (last visited Apr. 3, 2005). "It is against this backdrop that the United States embargo on shrimp and shrimp products harvested without the use of TEDs came to the WTO Dispute Panel and to the Appellate Body." Puls, *supra* note 25, at 371.

69. *Shrimp/Turtle*, *supra* note 10, at para. 117. *See generally* Bree, *supra* note 13.

70. Bree, *supra* note 13, at 106. The Appellate Body reiterated this point:

> In the present case, the Panel did not expressly examine the ordinary meaning of the words of Article XX. The Panel disregarded the fact that the introductory clauses of Article XX speak of the 'manner' in which measures sought to be justified are 'applied.' In [*Reformulated Gasoline*], we pointed out that the chapeau of Article XX 'by its express terms addresses, not so much the questioned measure or its specific contents as such, but rather the manner in which that measure is applied. . . . What the panel did, in purporting to examine the consistency of the measure with the chapeau of Article XX, was to focus repeatedly on the design of the measure itself. . . . The general design of a measure, as distinguished from its application, is, however, to be examined in the course of determining whether that measure falls within one or another of the paragraphs of Article XX following the chapeau.

Shrimp/Turtle, *supra* note 10, paras. 115-16.

Article XX—in particular, XX(g).[71] Noting the global effort and interest in the protection of living natural resources, the Appellate Body proceeded on these grounds, positing that measures to conserve exhaustible natural resources, whether living or nonliving, may fall within Article XX(g).[72] Under its Article XX(g) analysis, the Appellate Body concluded that sea turtles were an exhaustible natural resource[73] and that Section 609's aim was sufficiently related to the legitimate policy of sea turtle preservation.[74]

Thus, having found Section 609 to be within the meaning of Article XX(g), the Appellate Body proceeded to the most controversial step of all—deciding whether Section 609 satisfied the requirements of the chapeau of Article XX.

b. The Infamous Chapeau of Article XX

The Appellate Body's analysis of Article XX(g) is notable for both the legalistic methods it applied and the results it yielded.[75] Fulfillment of the requirements of Article XX(g), however, provides only for a provisional justification of compliance.[76] All examined regulations must also stand up to the mandate of the introductory clauses, or chapeau, of Article XX.[77]

The chapeau interjects two general requirements into the otherwise absolute provision that "nothing in this Agreement" shall prevent the adoption

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71. Article XX(g) was used because of the less harsh language it entailed. Instead of the "necessary" language of (b), (g) only specified that the measure be "related to" the protection of natural resources. Benedini, *supra* note 34, at 447.

72. *Shrimp/Turtle*, *supra* note 10, at para. 127.

73. According to the complainants, this definition of "exhaustible natural resources" represented the understanding common at the time that the original GATT was drafted in 1947. *Shrimp/Turtle*, *supra* note 10, at para. 128. The incorporation of GATT into the WTO framework in 1994 created a new interpretive context that the Appellate Body was bound to follow. Primarily, the Appellate Body referred to the textual interpretation of Article XX in finding that the term "exhaustible" does not exclude "renewable" resources like living animals. *Id.* The Appellate Body noted that the treaty must be read "in the light of contemporary concerns of the community of nations about the protection and conservation of the environment." *Id.* Therefore, the Body concluded the language of the treaty is not "static," but "by definition evolutionary." *Id.* Moreover, the Body acknowledged that the 1982 U.N. Convention on the Law of the Sea, the 1992 Agenda 21, the 1992 Biodiversity Convention, and the Convention on the Conservation of Migratory Species of Wild Animals include "living," "biological," or "natural" resources in their scope. *Id. See generally* Bree, *supra* note 13.

74. *Shrimp/Turtle*, *supra* note 10, at para. 142. The "related to" analysis focuses on the necessary relationship between the general structure and design of Section 609 and the conservation of sea turtles. The rationality test of sub-paragraph (g) is much broader than the necessity test of sub-paragraph (b), which requires that the only action that will be justified under (b) is the imposition of the least-trade-restrictive alternative. In contrast, the rationality test requires only "a close and genuine relationship of ends and means." The Appellate Body found that Section 609 did, in fact, have a sufficient relationship to the legitimate policy of conserving sea turtles. Dailey, *supra* note 4, at 367.

75. Bree, *supra* note 13, at 115.

76. *Id.* at 115-16.

77. *Id.* at 116.

of measures to achieve the policy goals enumerated in Article XX(a) through (j).[78] Specifically, it requires that measures not be applied in a manner which would constitute: (1) a means of arbitrary or unjustifiable discrimination between two countries where the same conditions prevail, or (2) a disguised restriction on international trade.[79]

While, in general, the parties to the *Shrimp/Turtle* dispute, the WTO, and environmental groups agree that the chapeau is designed to prevent the abuse of Article XX exceptions, the exact meaning and application intended by the ambiguous language of the dual requirements is a point of major contention.[80] It is here that the Appellate Body characterized its analysis as a balancing test—striking a balance "between the right of a Member to invoke an exception under Article XX and the duty of that same Member to respect the treaty rights of other Members."[81] In particular, the debate in the *Shrimp/Turtle* case examined the much-disputed question of whether and under what conditions the invocation of the environmental exception for unilateral trade restricting measures would constitute such an abuse.[82]

i. Unjustifiable and Arbitrary Discrimination

The Appellate Body first examined Section 609 with regard to the prohibition against unjustifiable or arbitrary discrimination.[83] This is where Section 609 ran afoul of Article XX.[84] In its holding that the unilateral legislation did unjustifiably and arbitrarily discriminate, the Appellate Body elicits several factors that led to this conclusion.[85]

According to the Appellate Body, the "most conspicuous flaw" in the application of Section 609 was its coercive effect.[86] While the statutory language of Section 609 did not mandate a change in policy by foreign governments, the Appellate Body believed that the practical application of the statute had removed any ostensible degree of flexibility toward compliance.[87] In particular, the Appellate Body pointed to the 1996 guidelines that had described only one manner in which a regulatory program could be considered comparable to the U.S. program.[88] "The Appellate Body found this 'rigid and unbending standard' in the application of Section 609 unacceptable, implying

78. GATT, *supra* note 57.
79. *Id. See also* Bree, *supra* note 13, at 106.
80. Bree, *supra* note 13, at 106.
81. *Shrimp/Turtle*, *supra* note 10, at para. 156; *see* O'Brien, *supra* note 67, at 301.
82. Bree, *supra* note 13, at 116-17.
83. *Shrimp/Turtle*, *supra* note 10, at para. 160.
84. *Id. See generally* Dailey, *supra* note 4, at 372.
85. O'Brien, *supra* note 67, at 301.
86. *Shrimp/Turtle*, *supra* note 10, at ¶165; *see also* O'Brien, *supra* note 67, at 301.
87. O'Brien, *supra* note 67, at 301.
88. *Id.*

that measures must take into account different conditions in the territories of other Members."[89]

The second and perhaps most substantively important aspect of the debate was what the Appellate Body referred to as the unilateral character of the measure's application.[90] Many legal pundits believe this was essentially the defining swing-vote in Section 609's analysis.[91] Indeed, the Appellate Body strongly criticized the

> failure of the United States to engage . . . [the appellees, as well as] other Members exporting shrimp to the United States, in serious, across-the-board negotiations with the objective of concluding bilateral or multilateral agreements for the protection and conservation of sea turtles, before enforcing the import prohibition against the shrimp exports of those other Members.[92]

As support for the appropriateness of such multilateral action, the Appellate Body cited to a series of international environmental and WTO environment related items, as well as to Section 609 itself.[93]

In addition, the Appellate Body bolstered its preference for multilateral negotiation by citing to the Inter-American Convention for the Protection and Conservation of Sea Turtles, a multi-national convention negotiated by the United States with some of the affected countries for the protection and conservation of sea turtles.[94] In its report, the Appellate Body extolled the Convention as a model for available multilateral alternatives.[95] Ironically, the Body used the United States's one multilateral success under Section 609 as an exhibit of the perceived greater failure in producing similar agreements with other Members.

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89. *Id.* (quoting the *Shirmp/Turtle* decision, *supra* note 10). It was unjustified, as the Appellate Body suggests, because other measures more acceptable to the exporting country might have achieved the legitimate conservation objective of the United States. Furthermore, the scheme as applied barred imports of shrimp caught with TEDs merely because they were caught in waters of countries not certified by the United States. Taken together, these two features of the scheme's application led to a conclusion of unjustified discrimination. The Appellate Body feared that the scheme's paramount concern was influencing WTO members to adopt essentially the same comprehensive regulatory regime as that applied by the United States to its domestic shrimpers. *Shrimp/Turtle*, *supra* note 10.

90. *Shrimp/Turtle*, supra note 10, at para. 163

91. *See, e.g.*, Bree, *supra* note 13.

92. *Id.* at 142 (explaining and analyzing the Report of the Appellate Body and its stated decision criteria).

93. *Shrimp/Turtle*, *supra* note 10.

94. Inter-American Convention for the Protection and Conservation of Sea Turtles, opened for signature Dec. 1, 1996, 37 I.L.M. 1246 [hereinafter IAC].

95. *Shrimp/Turtle*, *supra* note 10, at para. 167.

Finally, the Appellate Body detected that differential treatment was being given to various countries desiring certification.[96] The Body specifically referred to disparities in the length of phase-in period and in the transfer of TED technology to specific countries.[97]

ii. Disguised Restriction on International Trade

The Appellate Body did not specifically address the issue of whether the statute, in fact, constituted a "disguised restriction on international trade."[98] Therefore, the Appellate Body declared that it was enough that the measure be held inconsistent with Article XX because Section 609 constituted both unjustifiable and arbitrary discrimination.[99]

C. Unilateral Environmental Measures in the Wake of the Shrimp/Turtle Decision

Perhaps recognizing the political sensitivity of striking down an environmentally-friendly statute in favor of trade, the Appellate Body concluded its decision in *Shrimp/Turtle* with a recitation of what it did not decide: "We have not decided that the sovereign nations that are Members of the WTO cannot adopt effective measures to protect endangered species, such as sea turtles. Clearly, they can and should."[100] In paragraph 121, the Appellate Body even went so far as to indicate that unilateralism may, in fact, be a common aspect and application of Article XX(g) justifiable measures.[101]

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96. *Id.* at para. 173.

97. *Id.* Under the 1991 and 1993 guidelines, fourteen countries in the Caribbean and western Atlantic region had a phase-in period of three years, whereas all other states had only four months to implement the mandatory use of TEDs. The Appellate Body rejected the United States's explanation that the longer implementation period was justified by the undeveloped character of TED technology in 1991, while in 1996 improvements had made a shorter period possible. Moreover, the Body observed that "[f]ar greater efforts to transfer technology successfully were made to certain exporting countries," specifically the fourteen Caribbean and western Atlantic countries, than to other exporting countries. *Id. See also* Bree, *supra* note 13, at 115.

98. Dailey, *supra* note 4, at 374.

99. *Id.*

100. *Shrimp/Turtle*, *supra* note 10, at para. 185, *quoted in* O'Brien, *supra* note 67, at 301.

101. *Id.* The language and substance of paragraph 121 in the decision is worth quoting:

> In the present case, the Panel found that the United States measure at stake fell within that class of excluded measures because Section 609 conditions access to the domestic shrimp market of the United States on the adoption by exporting countries of certain conservation policies prescribed by the United States. It appears to us, however, that conditioning access to a Member's domestic market on whether exporting Members comply with, or adopt, a policy or policies unilaterally prescribed by the importing Member may, to some degree, be a common aspect of measures falling within the scope of one or another of the exceptions (a) to (j) of Article XX .... It is not necessary to assume that requiring from exporting countries compliance with, or adoption of, certain

However, the practical application of such an assertion is open for debate. While the Appellate Body's decision in *Shrimp/Turtle* appears to open the door to unilateral national environmental measures under Article XX(g), that "open door only leads to a second and more tightly guarded gateway, the Article XX chapeau."[102] Therefore, the arguments of earlier cases condemning unilateral measures under Article XX seem to have merely transferred bases from the interpretation of the exceptions to the interpretation of the chapeau. Was the Appellate Body correct? Can or should sovereign States be able to unilaterally effectuate environmental goals through the channels of trade? Opinions on this matter have led to a groundswell of legal comments and theory.

IV. THE ANATOMY OF A TRADE-RESTRICTIVE ENVIRONMENTAL MEASURE

Often overlooked in judicial decisions is the reaction of the party in whose favor the case has been decided. Yet the mere possibility that unilateral trade measures may be allowed in the future has the international trade community up in arms.[103] However, it is important to note that most analyses of the *Shrimp/Turtle* decision come from journals and publications not-so-coincidentally entitled with such names as "Journal of Environmental Law" and "Environmental Law Reporter."[104]

Therefore, was the Appellate Body's interpretation of the chapeau in *Shrimp/Turtle* as egregious as advertised? Was the United States the good and noble Defender of Wildlife it was portrayed to be? Such matters warrant a closer look.

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policies (although covered in principle by one or another of the exceptions) prescribed by the importing country, renders a measure a priori incapable of justification under Art. XX. Such an interpretation renders most, if not all, of the specific exceptions of Article XX inutile, a result abhorrent to the principles of interpretation we are bound to apply.

Id. at para. 121.

102. Gaines, *supra* note 18, at 743.

103. A fairly representative criticism is that of Jagdish Baghwati of Columbia University:

I have some sympathy for [the] view that the dispute settlement panels and the appellate court must defer somewhat more to the political process instead of making law in controversial matters. I was astounded that the appellate court, in effect, reversed long-standing jurisprudence on process and production methods in the *Shrimp-Turtle* case. I have little doubt that the jurists were reflecting the political pressures brought by the rich-country environmental NGOs and essentially made law that affected the developing countries adversely.

Jagdish Bhagwati, *After Seattle: Free Trade and the WTO, in* EFFICIENCY, EQUITY, AND LEGITIMACY: THE MULILATERAL TRADING SYSTEM AT THE MILLENNIUM 60-61 (Roger B. Porter et al. eds., 2001); *see also* Claude E. Barfield, FREE TRADE, SOVEREIGNTY, DEMOCRACY: THE FUTURE OF THE WORLD TRADE ORGANIZATION 37-70 (2001).

104. *See, e.g.*, Guruswamy, *supra* note 20; Cadeddu, *supra* note 11.

A. Trade and the Environment

To fully appreciate the nature of the WTO's current predicament over Article XX, one must recall the contentious decade of trade versus environment debate preceding the *Shrimp/Turtle* decision.[105] "In 1991, a dispute settlement panel report [unwittingly] thrust trade law abruptly into the realm of environmental policy, and, in so doing, placed environmental issues squarely on the agenda of international trade policy and development."[106] The resulting aftershock from the report created ripples throughout the environmental and trade communities alike.[107] Environmentalists portrayed the world trade system as "GATTzilla," while trade advocates predicted a period of veiled trade restrictions and "green" protectionism that threatened to revert the international community back to the chaos that embroiled the 1930s.[108]

Still, optimism fueled the hope that the worlds of trade and environment could find a common ground that would be mutually beneficial to both of their interests.[109] The GATT soon had created a Group on Environmental Measures and International Trade (EMIT), later restructured in 1995 as the Committee on Trade and Environment (CTE).[110] In addition, the Organization for Economic Cooperation and Development studied issues viewed as germane to the trade versus environment debate through a series of meetings of an ad hoc group called the Joint Session of Trade and Environment Experts.[111] Academic studies and conferences addressing trade and the environment proliferated.[112]

These ten years of regular intergovernmental meetings since *Tuna-Dolphin I* effectively deepened our understanding of the issues; however, they still have yielded only minimal progress in official negotiations toward new trade-environment policy approaches.[113] While many WTO Members continue to claim that there should be no policy contradiction "between upholding and safeguarding an open, non-discriminatory and equitable multilateral trading system on the one hand, and acting for the protection of the environment, and the promotion of sustainable development on the other,"[114] the reality, of course, is that this is much more difficult in practice. The violent street demonstrations at the 1999 Seattle meeting of WTO trade ministers, repeated since in many other cities, symbolize the deep mutual suspicion and clash of values that exist between trade and the environment.[115]

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105. Gaines, *supra* note 18, at 752.
106. *Id.* *See* GATT, *supra* note 57.
107. Gaines, *supra* note 18, at 752.
108. *Id.* at 752.
109. *Id.* at 753.
110. *Id.*
111. *Id.*
112. *Id.* at 753-54.
113. *Id.* at 754.
114. Bree, *supra* note 13, at 102.
115. *See* Gaines, *supra* note 18, at 756.

Conflicts over trade and the environment continue to arise and need to be resolved. Given the absence of official negotiations toward new policy approaches, governments in most such cases have had no option but to resort to the dispute settlement process of the GATT/WTO. Not surprisingly, most of these cases have met with very little success toward their environmentally-based objectives. Nevertheless, while some critics contend the *Shrimp/Turtle* case has made unprecedented inroads into state sovereignty (actually, the sovereignty of the United States, to be more exact) and the conservation and protection of the environment, the final decision of the Appellate Body may merit some support.

B. Were the United States' Efforts Genuinely Environmentally Motivated?

Harnessing memories from their first year of law school, many lawyers will recall a standing case entitled *Lujan v. Defenders of Wildlife*.[116] The moniker "Defenders of Wildlife" conjures up a sort of haughty imagery. What kind of organization would call itself the Defenders of Wildlife? Who, in fact, *were* the Defenders of Wildlife? To listen to some of the critiques of *Shrimp/Turtle*,[117] this venerable title had vested in the United States of America, attained as a result of its visionary environmental legislation—Section 609. Nonetheless, were the United States's efforts in *Shrimp/Turtle* genuinely environmentally motivated, and should it matter if they were not?

After all, "according to a recent status report to the WTO, the United States has 'redoubled its efforts . . . to negotiate an agreement with the governments of the Indian Ocean region towards the protection of sea turtles in that region.'"[118] The report further stated that several governments as well as NGOs had already been approached in an effort to get the negotiations process underway toward a more effective multilateral treaty.[119] These findings beg the question: Why was this option not implemented from the very beginning?

In fact, the global shrimp industry is one of the highest-valued seafood industries in the world, and the United States is one of the largest consumers of shrimp, typically importing about 75 percent of the shrimp that it consumes.[120] Therefore, it may be, as one author contends, that the United States, by imposing restrictions on imported shrimp, hoped to limit foreign competition in favor of its domestic shrimp industry.[121]

Suspicion in the neutral eye is inevitable. The facts materialize themselves as the classic case of protectionism. As Peter Chessick describes,

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116. 504 U.S. 555 (1992).

117. *See, e.g.*, Guruswamy, *supra* note 20.

118. Benedini, *supra* note 34, at 447.

119. *Id.*

120. Peter Chessick, *Explaining U.S. Policy on* Shrimp-Turtle*: An International Business Diplomacy Analysis, in* RECONCILING ENVIRONMENT AND TRADE 497 (Edith Brown Weiss & John H. Jackson eds., 2001).

121. *Id.* at 501.

"[a]fter the domestic TEDs regulations were in place, unhappy Trawlers in the Gulf of Mexico, forced to put TEDs in their nets, found themselves trawling alongside Mexican Trawlers who were subject to no such requirements, yet who could sell their presumably larger catches for the same price."[122] So, perhaps not so coincidentally, in 1989, less than two years after the Department of *Commerce* first required the use of TEDs by U.S. shrimpers, Congress passed the amendment to the Endangered Species Act known as Section 609.[123] In fact, when Section 609 was finally implemented in 1991, the State Department issued guidelines that directed efforts to enforce subparagraph (b)'s restrictions on only 14 of the 85 countries exporting shrimp to the U.S., and those efforts led to further actions against only one country: Mexico.[124]

Furthermore, Section 609 itself was proposed by members of Congress from states bordering on the Gulf of Mexico, which is by far the greatest source of domestic shrimp (and shrimpers) in the United States.[125] The environmental lobby had very little influence on the development of the legislation, and it did not become deeply involved in the Section 609 debate until the 1991 guidelines were released.[126]

C. The International Trade Community's Argument

So, after the dust settled, who was the real "winner" and who was the real "loser" in the *Shrimp/Turtle* case? The answer may not be patently obvious. After all, government representatives from Thailand and India have asserted that, from their point of view, the United States really "won" due to what they perceived as the Appellate Body's broad reading of the Article XX exceptions.[127] "As with so many matters in the law, the practical result for the parties to the case is, for many purposes, secondary to its significance as legal discourse and potential precedent."[128]

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122. *Id.* at 515.

123. *Id.*

124. *Id.* at 499.

125. "Section 609 was actually an amendment to a much larger appropriations bill, and was sponsored by several Congressmen from the Gulf states, led by Senator John Breaux from Louisiana." *Id.* at 515.

126. *See* Earth Island Inst. v. Christopher, 942 F. Supp. 597 (Ct. Int'l Trade, 1996), *vacated on other grounds*, Earth Island Inst. v. Albright, 147 F.3d 1352, 1354-55 (Fed. Cir. 1998). These interests were demonstrated in the Earth Island Institute lawsuit filed against the State Department. *Id.* The plaintiffs argued that the geographically limited scope and enforcement set forth by the guidelines was, in fact, contrary to the language of Section 609. *Id* at 1355. Joining the Earth Island Institute in the action were the American Society for the Prevention of Cruelty to Animals, the Humane Society for the Prevention of Cruelty to Animals, the Sierra Club, and, interestingly, the Georgia Fishermen's Association, Inc. *Id.* at 1354-55. One author noted that the Georgia Fishermen's Association was the only shrimping organization that joined in the lawsuit. *See* Chessick, *supra* note 120, at 516.

127. Gaines, *supra* note 18, at 749.

128. *Id.*

Specifically, the international trade community protests the *Shrimp/Turtle* holding in the sense that it leaves the door cracked open for countries to unilaterally impose extraterritorial trade restrictions based on individual, domestic agendas—perhaps more importantly—without necessitating changes to the WTO rules.[129] As Alan Oxley, former Australian Ambassador to the GATT and former Chairman of the GATT Contracting Parties, exclaimed:

> This judgment of the Appellate Body follows the example set by the most activist of the U.S. Supreme Court judges. It has interpreted WTO provisions to permit restrictions which the membership of the WTO has previously indicated, overwhelmingly and emphatically, they do not support. . . . There is now an urgent need to quarantine or, better, reverse, the opening for widespread imposition of trade restrictions on environmental grounds which the AB has now legitimized.[130]

Given the Appellate Body's corresponding interpretation of the chapeau, however, such fears may be more alarmist than real. Nevertheless, through all of the discussion, accusations, and conjecture, one cannot help but wonder: Regardless of the complete purity of motive, should unilateral measures ever be allowed if a salient, environmental reason for such measures can be legitimately shown to exist?

D. Unilateral Measures May Be Necessary

There are essentially two types of environmental trade measures: multilateral and unilateral. This distinction is paramount because the WTO has consistently favored the use of multilateral environmental trade measures over

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129. ALAN OXLEY, INT'L TRADE STRATEGIES LTD., IMPLICATIONS OF THE DECISIONS IN THE WTO SHRIMP TURTLE DISPUTE (Feb. 2002), http://www.worldgrowth.org/pages/PDFs/shrimp-turtle.pdf (last visited Apr. 3, 2005). Aside from unilateralism, Oxley makes additional arguments of what he views as dangerous precedents to which the Appellate Body opened the door:

- Article XX(g) can have extraterritorial reach
- A trade restriction can be imposed on a product if the way it is processed has negative environmental consequences as determined by the importer;
- International declarations and conventions, regardless of whether or not they have widespread support or adherence, create legitimate grounds to trigger the use of the exceptions under Article XX;
- Non-trade elements of the Preamble, e.g., "sustainable development," now diminish the standing of the international trade responsibilities of the WTO as its primary purpose.

Id. at 4.

130. *Id.* at 3-4.

unilateral environmental measures that propose the same goals.[131] These sentiments were echoed in recent comments by Renato Ruggiero, former Director-General of the WTO:

> We both want a strong, rules-based trading system as well as a strong and effective environmental system, and we both want the two systems to support one another. The question is how do we arrive at these objectives. We will not arrive there through unilateralism, through discriminatory actions and protectionism, with each nation free to impose its standards and priorities on the other following its own perceptions of the problem. On the contrary, we will only arrive at our shared objectives through consensus, through negotiations.[132]

Indeed, international environmental law and policy has expressed a preference for multilateral treaties and negotiations, as well.[133] The reasons are really quite obvious. Attending to such global threats as species extinction, multilateral cooperation, and parity is seen as more effective and equitable than unilateral measures, which can slant the playing field in the direction of Northern power and open the door to serious abuses. After all, in the current state of the world, the line between economics and environment is often blurred, and the color of environmental trade measures is very rarely black or white.

Despite this pronounced desirability for multilateral treaties, and the fact that the United States may not have been as genuinely environmentally motivated as it was portrayed to have been, there are problems with pursuing a

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131. The Appellate Body has acknowledged that the task of interpreting and applying the chapeau is, hence, essentially the delicate one of locating and marking out a line of equilibrium between the right of a Member to invoke an exception under Article XX and the rights of other Members under varying substantive provisions of the GATT, so that neither of the competing rights will cancel out the other. *Shrimp/Turtle*, *supra* note 10; *see also* Puls, *supra* note 25, at 345.

132. Benedini, *supra* note 34, at 434.

133. *See* Declaration of the United Nations Conference on the Human Environment, June 16, 1972, 11 I.L.M. 1416 (1972), *available at* http://www.unep.org/Documents/Default.asp?DocumentID=97&ArticleID=1503 (last visited Apr. 3, 2005). For a descriptive analysis of the drafting of the provisions of the Declaration, see Louis B. Sohn, *The Stockholm Declaration on the Human Environment*, 14 HARV. INT'L L.J. 423 (1973); *see also* Article 2.19, Agenda 21, UN Doc. A/CONF.151/426 (1992). At the same time, Principle 12 of the Rio Declaration calls for states to cooperate to promote an "open international economic system that would lead to growth and sustainable development in all countries." AMERICAN MODEL UNITED NATIONS INTERNATIONAL, POSITION PAPERS BY COMMITTEE, ANUM 2004 – POLICY STATEMENTS FOR THE ECOSOC COMMISSION ON SUSTAINABLE DEVELOPMENT, *at* http://www.amun.org/amun_ppr_bycomm.php?comm=ESComm (n.d.) (last visited Apr. 8, 2005). However, it further provides that unilateral measures aimed at extra-territorial environmental problems are to be avoided, and "environmental measures addressing transboundary or global environmental problems should, as far as possible, be based on an international consensus." *Id.*

negotiated multilateral solution to environmental threats. In the absence of an international judicial system that provides a comprehensive and neutral dispute resolution body able to blindly cover conflicts such as the *Shrimp/Turtle* dispute, unilateral measures may be necessary to protect a species' already delicate status.

1. No Time for Multilateral Inefficiencies

Environmental threats present somewhat unique phenomena. In general, by the time the environmental threats gain public attention, the situation has attained advanced status, and the need for a cogent solution has become critical.[134] Therefore, there is often little room for error and no time to waste. Curiously, these are exactly the results multilateral negotiations threaten to produce.

International negotiations are usually long, complex, expensive, and highly politicized processes.[135] As Robert Howse observed:

> In a world where bargaining imposes transaction costs, cooperative solutions will be affected by background legal rules that establish rights or entitlements on which the parties can rely in the absence of negotiated agreement. It is possible that a rule that is highly restrictive of unilateral trade measures to protect the environment will lead to strategic behavior, and exacerbate hold-out problems, thereby increasing transaction costs and reducing the likelihood of cooperative solutions to global environmental problems.[136]

Perhaps more importantly, by the time the countries can find an agreement that is copasetic to all parties, the species in question may be extinct.

2. Absence of an Impartial Forum[137]

Similarly, unilateral measures may become necessary due to the absence of an impartial forum. As mentioned earlier, the lack of an international judicial system with a less specialized purpose and a more comprehensive and

134. Benedini, *supra* note 34, at 436.

135. *Id.*

136. Howse, *supra* note 68, at 492.

137. At least one author has proposed the United Nations Convention on the Law of the Sea (UNCLOS) as a more impartial alternative to the WTO. *See* Guruswamy, *supra* note 20, at 10274 ("In light of all the shortcomings of GATT/WTO tribunals as a forum for trade and environment disputes, it is useful at this point to emphasize the importance and viability of UNCLOS as another international forum for such cases."). *See generally* United Nations, Division for Ocean Affairs and the Law of the Sea, *Oceans and Law of the Sea, at* http://www.un.org/Depts/los/index.htm (last visited Apr. 3, 2005).

neutral dispute settlement body has led to conflict and divergent policies within the international community. Was the Appellate Body wrong in concluding that the United States may have discriminated against certain countries in the *Shrimp/Turtle* case under the guise of environmental protection? Probably not. Nevertheless, would a more neutral arbiter have come to a different decision? This question is a more difficult one to answer, but this Article argues "yes."

a. The "T" Stands for Trade

The simple fact remains: The GATT/WTO regime is first and foremost a trade organization.[138] Its Dispute Panels and Appellate Body consist almost exclusively of trade experts and free trade advocates.[139] Nevertheless, without a fully evolved international court system, environmental measures disputed for their effect on trade must still come before a WTO Dispute Panel and, if appealed, before a WTO Appellate Body.[140] Needless to say, this process hardly presents the image of impartiality.

So, why would a more neutral arbiter have decided any differently? For one thing, the Appellate Body ignored pertinent customary international law, not the least of which was the principle of sustainable development, and in so doing, showed little understanding for how environmental policy works.

b. The Appellate Body Exhibited Ignorance to the Principle of Sustainable Development

Most negative critiques of the *Shrimp/Turtle* decision have focused on the perceived incorrect interpretation and application of GATT Article XX and its exceptions. As discussed above, however, the WTO owes its existence and devotes its loyalty to the insurance of fair trade. Therefore, it is to be expected, as well as encouraged, that the WTO interpret their rules and regulations in this light. After all, outside of the gambit of *Shrimp/Turtle*, the WTO performs necessary and laudable functions. Who is more privy to the meaning and intent of such rules and regulations than the original drafter and facilitator? Where the Appellate Body treads more clumsily, though, is in its display of ignorance toward pertinent customary international law, particularly the concept of sustainable development. Indeed, it is this ignorance that represents the less forgivable offense and better displays the need for a more impartial forum.

Professor Birnie has indicated that the *Gabčíkovo-Nagymaros* case shows us that "a treaty may also have to be interpreted and applied in light of customary international law, including new environmental law."[141] While

138. Puls, *supra* note 25, at 351.

139. *Id.*

140. *Id.* at 350-51.

141. PATRICIA BIRNIE & ALAN BOYLE, INTERNATIONAL LAW & THE ENVIRONMENT 80 (2d ed. 2002).

Birnie acknowledges that how courts resolve the potential for conflict between simultaneously applicable principles or norms in international disputes is essentially a matter of judicial technique, she also points out that the case law of the International Court suggests that where possible it "prefers an integrated conception of international law to a fragmented one."[142] "Apart from highlighting the formative role of international courts in determining the applicable law, this conclusion points again to the [tenuous practice] of viewing any part of international law in isolation from the whole."[143]

Admittedly, contentious debate surrounds whether or not the principle of sustainable development has risen to the level of customary international law. Nevertheless, at least one court and more than a few legal commentators have espoused its status as such.[144] Even so, in referencing and applying sustainable development throughout the body and preamble to its constitutive agreement, the WTO may have incorporated the principle into GATT and, moreover, possibly raised its status concerning *Shrimp/Turtle* to that of the binding law of treaties.

The guidelines for interpreting treaties are given in the Vienna Convention on the Law of Treaties.[145] Article 31(1) stipulates that "[a] treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose."[146] The Convention later specifies the need that the treaty be interpreted as a whole, "including its preamble and annexes."[147] Therefore, in seeking to understand and apply the meaning of a GATT provision, for example, it may not be enough to look only to the text of the particular provision.[148]

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142. *Id.*

143. *Id.* at 80-81.

144. *See, e.g.*, Dailey, *supra* note 4, at 347-48.

> [I]n the last twenty years, the principle of sustainable development has become accepted as a rule of customary international law.... The multilateral consensus supporting the rule of sustainable development has been broad and consistent for the last twenty years. The state practice and opinio juris supporting the principle of sustainable development are sufficiently strong to create an international legal obligation on the part of nations to exploit their resources in a manner that is sustainable.

Id. Dailey even alludes to the fact that a former Director-General of the GATT, Peter Sutherland, recognized the fact that because sustainable development "has become a customary rule of law, [it] must be addressed by the GATT." *Id* at 344; *see also* Case Concerning the Gabcikovo-Nagymaros Project, 37 I.L.M. 162 (1998), *available at* http://www.icj-cij.org/icjwww/idocket/ihs/ ihsjudgement/ihs_ijudgment_970925_frame.htm (last visited Apr. 3, 2005).

145. Vienna Convention on the Law of Treaties, May 23, 1969, 1155 U.N.T.S. 331 [hereinafter Vienna Convention]. *See generally* I. SINCLAIR, THE VIENNA CONVENTION ON THE LAW OF TREATIES (2d ed. 1984).

146. Vienna Convention, *supra* note 145, at 691-92.

147. *Id.* at 692.

148. *Id.*

This is where the Appellate Body's analysis of *Shrimp/Turtle* and viability as a neutral and fair arbiter of trade-environment disputes breaks down. In its preamble, "the WTO [purports to have] a commitment to 'an open, non-discriminatory and equitable multilateral trading system on the one hand,' and to 'protection of the environment, and promotion of sustainable development on the other.'"[149] Yet, the Appellate Body never whole-heartedly addresses or applies these dual principles whereas a non-trade organization probably would have.

It is a paradox that can only be explained by the need for a more impartial forum. Commentator Virginia Dailey characterizes the frustration: "In the trade-environment cases, the Panels and the Appellate Body have repeatedly lamented the lack of an international standard to apply, but their actions ignore a well-established, overarching international environmental standard—the principle of sustainable development—that exists with or without a treaty on point."[150]

V. CONCLUSION

In 2001, one of the *Shrimp/Turtle* complainants, Malaysia, challenged the corrective measures the United States had taken in response to the Appellate Body's decision.[151] Following three years of some of the harshest and most scathing criticism any international law decision has ever faced, the Appellate Body was ready to clarify and expand upon its original *Shrimp/Turtle* ruling. This second Appellate Body panel found that the United States had brought its turtle-friendly trade measures into compliance with Article XX, and it further underscored those aspects of its original ruling that were alleged to constitute a fundamental departure from the more polarizing *Tuna/Dolphin* rulings.[152] Nevertheless, whether the 2001 panel's ruling represented an attempt to clarify its stance concerning the use of unilateral trade measures, or whether it merely represented an attempt to vitiate the critical attacks of the 1996 panel's rulings and maintain its legitimacy as arbiters of environmentally important trade decisions, remains to be seen. Indeed, the curious eye gazes toward the future.

Regardless of future holdings, in concluding that Section 609 violated the conditions established by the chapeau, the Appellate Body unduly privileged trade considerations, showed little understanding of how customary international law or environmental policy works, and gave little hope that the

149. Gaines, *supra* note 18, at 739 (emphasis added) (quoting Preamble of the (Marrakesh) Ministerial Decision on Trade and Environment, April 15, 1994, GATT/MTN.TNC/MIN(94)/1/Rev.1).

150. Dailey, *supra* note 4, at 379.

151. Report of the Appellate Body on *United States—Import Prohibitions of Certain Shrimp & Shrimp Products*; Recourses to Article 21.5 of the DSU by Malaysia, WT/DS58/AB/RW (October 22, 2001), *available at* http://www.wto.org/english/tratop_e/dispu_e/distabase_e.htm.

152. *Id.*

WTO will ever tolerate any real-world unilateral measures related to the protection and conservation of the environment. In so doing, the decision in *Shrimp/Turtle* joins a long line of disputes settled in the WTO (and under the predecessor GATT) in which the trade organization has rejected Article XX exceptions for national environmental measures that may restrict trade. Meanwhile, the sea turtles go unprotected.

LEGAL CHALLENGES OF GLOBALIZATION

Flerida Ruth P. Romero*

I. INTRODUCTION: GLOBALIZATION AND THE VANISHING INDEPENDENT STATE

By now, the word "globalization" is as worn out with use as an old vinyl record. Everyone is using it, whether talking about goods, services, information, or technology. Even in the sphere of the law, globalization has in recent times taken center stage. But what indeed is this phenomenon called "globalization"?

I remember coming across a story on the Internet about how the death of Princess Diana could be used to illustrate globalization. Here was an English Princess who, with her Egyptian boyfriend, died in a French tunnel while riding a German car driven by a Belgian chauffeur drunk on Scottish whiskey, while being hounded by Italian Paparazzi on Japanese motorcycles. American doctors attempted to save them using Brazilian medicine. Millions of Internet surfers were able to read this story on one of the IBM clones that use Taiwanese-made chips and Korean-made monitors assembled by Bangladeshi workers in a Singapore plant then transported by lorries driven by Indians. It is tragic in that it really happened; funny in some ways but not entirely false or misleading.

Globalization is loosely defined as "integration and democratization of the world's culture, economy and infrastructure through trans-national investment, rapid proliferation of communication and information technologies, and the impact of free-market forces on local, regional and national economies."[1]

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* Judge of the Administrative Tribunal of the International Labour Organization (Geneva) and President of the Administrative Tribunal of the Asian Development Bank. A retired Justice of the Supreme Court of the Philippines, she is a member of the Board of Visitors of the Inidiana University School of Law – Bloomington, where she obtained her LL.M. and LL.D. (*honoris causa*) degrees. She obtained her A.B. and LL.B. degrees from the University of the Philippines (U.P.). She taught at the U.P.College of Law for more than twenty years, six of which she served concurrently as Director of the U.P. Law Center. She capped her academic career with an appointment to the U.P. policy-making Board of Regents.

After the People Power Revolution of 1986, during which Corazon C. Aquino rose to the Presidency of the Republic of the Philippines, she was appointed Secretary General of the Constitutional Commission of 1986. Upon the ratification of the constitution, she became Special Assistant to President Aquino. In 1991, she was appointed Justice of the Supreme Court of the Philippines, where she served until 1999. Currently, she is actively engaged in the arbitration of international and domestic commercial disputes and continues to be involved in the Committee on the Revision of the Rules of the Supureme Court of the Philippines.

1. MICROSOFT ENCARTA REFERENCE LIBRARY, GLOBALIZATION (2003).

From this definition, one can instantly discern a heightened "connection," or networking, if you will, among nations and peoples through trade, travel, and information exchange. It is an inter-connection that has, in fact, existed for many centuries, but the invention of machines has greatly accelerated the pace of development in these three areas.

By the turn of the first millennium, the seeds of globalization had already taken root in the eastern hemisphere, particularly in the lands bordering the Indian Ocean and South China Sea. These were the most dynamic regions in the world at the time, and trade was the primary motivation of the advanced Asian cultures in reaching out to unknown territories. Western civilization, by contrast, was still in its seminal phase. Interaction with the traders was the spark they needed to catch up. It took more than half a millennium, however, before the great thinkers of Europe began to recognize transplanted eastern wisdom. The Renaissance eventually ushered in rapid development in keeping with the growing population. Explorers from the great western powers of the time – England, Spain, Portugal, France, the Netherlands – reached the remote corners of the Earth, purposely or at times fortuitously, bringing with them not just goods for trading, but also religions and ideologies for mental subjugation, hand in hand with superior military equipment for physical conquest. Yet, despite the shadow cast by such show of force, it cannot be denied that the seeds of globalization, as earlier defined, were starting to take root.

The 20th century saw the heightened globalization of services and information. Spurred by the earlier Industrial Revolution and the opening of the frontiers of the United States of America, the West began to overtake the Eastern powers which had been mired in their own concepts of tried and tested greatness vis-à-vis what they perceived to be the modern ways of "hairy barbarians." By the end of the Second World War, the West was dictating the course of world trade, including the way nations ought to behave in conducting it.

It was also in the 20th century where several new developments quickened the pace of globalization and strengthened the economic links among countries. One of the most important changes was the diminished transportation costs, made possible by the availability of less expensive oil and the invention of energy-saving devices. Another key development was the emergence of more and more multinationals – the modern symbol of globalization. While misgivings have been expressed regarding the effects of multinational corporations on the economy and the worker population, especially those in developing countries, a Columbia University economist, Jagdish Bhagwati, states that "studies find that they actually pay a 'wage premium' – an average wage that exceeds the going rate in the areas where they

are found, ranging from 40% to 100%." He asserts that foreign corporations with better technology and management practices provide technology transfer, new ideas and expectations and increased competition in the local job market.[2]

A third factor that promoted globalization was the creation of international economic institutions – such as the International Bank for Reconstruction and Development (the World Bank), the International Monetary Fund (IMF), and the World Trade Organization (WTO) – to help regulate the flow of free and fair trade and money among nations. The duties of the 147-member WTO, successor to the General Agreement on Tariffs and Trade (GATT), include, among others, administering trade agreements, acting as a forum for trade negotiations, and assisting developing countries. To dispel any doubt that the United States is now, more than ever, integrated with the world economy, the WTO's Director-General, Supachai Panitchpakdi, has stated that "a quarter of U.S. Gross Domestic Product is tied to international trade, up from 10% in 1970". America's wider global objectives, such as fighting terrorism, reducing poverty, improving health, integrating China, and other countries in the global economy, are seen as linked, in one way or another to world trade."[3] The latest WTO framework agreement lays down the basic aim of the talks, "to establish a fair and market-oriented trading system through a programme of fundamental reform." But the final balance must grant special treatment for developing countries, where agriculture is of critical importance to economic development. Developing countries had blamed lavish subsidies paid to farmers mainly in rich countries for driving down prices and effectively sidelining them on world markets.

Finally, advances in telecommunications and computer technology made it much easier for people to communicate with each other and to conduct their business. Managers, for example, can now easily coordinate the global activities of their organization involving various corporate divisions, clients, and suppliers, without even leaving their headquarters.

But globalization has its dark, ugly side too. Events in one country may have serious consequences for ordinary people in another part of the world. In the late 1990s, for example, a long economic recession in Japan spread to Southeast Asia. The countries of Southeast Asia had relied on Japanese banks for money to prop up their economies and on Japanese consumers to buy their products. The recession prompted Japanese banks to curtail their investments and purchases, causing many other Asian economies to flounder. Eventually other foreign investors panicked and pulled their money out of Southeast Asia. Consequently, thousands of Thais, Indonesians, Filipinos, and many others in

2. Jagdish Bhagwati, *Do Multinational Corporations Hurt Poor Countries?*, AMERICAN ENTERPRISE, June 2004, *available at* http://www.taemag.com/issues/articleid.18014/article_detail.asp.

3. Jill Jusko, *The Two Sides of Trade*, INDUSTRYWEEK, Apr. 1, 2004, *available at* http://www.industryweek.com/currentArticles/asp/articles.asp?ArticleId=1590.

the Pacific Rim lost their jobs. While the crisis has passed, the effects of that economic "Asian Flu" are still being felt in some quarters.

It is too recent to forget the Severe Acute Respiratory Syndrome (SARS) epidemic which first appeared in Guangdong, China in 2003. But because the Chinese authorities opted to suppress information about this menace at a time when such news would have been easily picked up and disseminated world-wide, the virus grew out of bounds and quickly spread to other Asian countries like Hong Kong, Singapore, Vietnam, Taiwan and crossed the Pacific to Canada. It was a retired military Communist doctor who, learning of the alarming number of SARS cases and deaths in the capital, wrote to the press revealing the true figures and, at great risk, signed his name. His revelations, corroborated by other Chinese doctors and the World Health Organization (WHO), helped to contain a potential global epidemic. This modern-day hero, Dr. Jiang Yanyong, received the Ramon Magsaysay Award, the equivalent in Asia of the Nobel Prize, in August, 2004, in Manila for breaking China's habit of silence and forcing the truth of SARS into the open. At bottom, what should have been merely a domestic health problem, soon raised questions of possible violation of global human rights which had implications on political rights, law, and politics, as well as social policy. For to contain the epidemic, governments were forced to quarantine infected areas, condemn and slaughter suspected animal carriers by the thousands and impose stringent health measures in ports of entry to the extent of rejecting possible carriers into their borders. It is no exaggeration to state that countries in my region are still jittery over the possible spread of other highly contagious diseases like "mad cow disease," avian flu and AIDS.

Throughout the world, both rich and poor countries have increasingly been economically dependent on one another. Perhaps with the exception of the behemoth U.S. and Chinese economies, they face problems with global dimensions. This includes the ultimate example of a global challenge – the assault on our ecological system. High rates of consumption coupled with economic desperation have led to such environmental pressures as the depletion of resources, the generation of pollution and the conversion of natural habitats for economic uses. In the long term, the success of globalization may well depend on its ability to bring about and sustain economic wellbeing to all of the world's inhabitants without causing further environmental damage.

The enjoyment of the benefits of progress, as well as the acceptance of attached responsibilities, is no longer the exclusive prerogative and burden of a single nation or a single race. Now, more than ever, global cooperation is necessary if we are ever to continue reaping the blessings of mutuality.

II. LEGAL AND JUDICIAL GLOBALIZATION

While initially, the phenomenon of globalization took place within an economic context, it was inevitable that it should have ramifications on the entire social and cultural fabric of the countries affected. All too soon, domestic wranglings were exploding into conflict situations of trans-national

proportions that threatened to disrupt harmonious relations between and among racial and ethnic groupings, not to mention developed nation-states. Responding to internal and external pressures, informal arrangements and laws had to undergo reformation, mechanisms were devised and novel infrastructure established to cope with situations never foreseen. Also, these arrangements and reforms had to take into account the idiosyncrasies of developing private international law.

Even as law was evolving through a natural process of internal growth, and subtle adventitious accretions, a more radical but artificial means of altering the legal terrain of nations was taking place in the wake of armed conquest. Through military might, subjugating powers were effecting the unilateral transplantation of entire systems of laws upon the unwilling populace of conquered territories. At certain stages in the history of mankind, alien laws, regardless of their affinity with indigenous practices, have been superimposed upon the customs and folk beliefs of native inhabitants.

Let me take a leaf from the history of my own country, the Philippines. When the Spanish "conquistadores," with the sword in one hand and the Cross in the other, overran our country, they ruled through edicts which emanated from the mother country. The Spanish Civil Code which traced its origins from the Roman Law and the Napoleonic Code regulated the personal and property relationships of the people for over three hundred fifty years – from the 16th to the 19th centuries.

At the threshold of the 20th century, American forces defeated the Spanish monarchy and established their nation's sovereignty in the Philippines. Erecting a form of government patterned after that of the United States, the drafters of our historic Charter drew liberally from the American model which subsequently evolved into the 1935 Constitution of the Philippines, the dominant features of which were a republican form of government and a Bill of Rights. As we all know, the libertarian political and social philosophies of such theorists and thinkers of the French Revolution as Montesquieu and Jean Jacques Rousseau had, in the nineteenth and twentieth centuries, profoundly affected the spirit and the basic framework of the Constitution of the United States: the first, by his postulate that governmental powers should be lodged in separate executive, legislative, and judicial bodies to safeguard personal liberty, and the second, by his social contract theory that sovereignty ultimately resides in the people regardless of the fact that this attribute had been delegated to the government when men formed a social contract to live in society. Thus, the seeds of popular sovereignty and democratic rights from the Old World found fertile ground for growth in the Philippines through the instrumentality of the Anglo-American common law which had by then, diluted the Romanesque influence of Spanish Civil Law. Clearly, the foundations of nascent legal and judicial globalization were already being laid on both sides of the Atlantic and the Pacific.

During the relatively brief interludes of the Commonwealth and the Republican form of governments under American sovereignty in the first half

of the twentieth century, American jurisprudence and case law were extensively applied in the resolution of disputes, initially, by the American Justices appointed to the Supreme Court of the Philippines and later, by U.S.-trained jurists. Allow me to mention that the first batch of such judges sent by the Philippine government as "pensionados" under scholarship grants were enrolled at the Law School of Indiana University. In fact, there now stands a building at the Bloomington campus named in honor of Dr. Jorge C. Bocobo whom a scholar has described as the "Father of the Brown Race Civil Code". He brought honor to us Indiana University alumni when his legal prowess was recognized by his appointment as Justice of the Supreme Court and President of the state-owned and operated University of the Philippines.

With more than two hundred years of interpreting constitutional human rights behind it, American jurisprudence has made a profound impact, not only on former colonies like the Philippines, but also on other independent, freedom-loving states and their judiciaries. These have found their way into foreign laws, not merely through the process of reception, then adoption of case decisions, but to a growing extent, through dialogue and "cross-pollination" among jurisdictions. The same factors that led to globalization by leaps and bounds in the economic and other fields of human endeavour in the last century have been responsible for producing a global legal world.

In her perceptive analysis presented in her paper on "The State of the International Judicial Community at the Outset of the 21st Century,"[4] Justice of the Supreme Court of Canada and immediate past President of the International Commission of, Jurists Claire L'Heureux-Dube, cited the following reasons for the increasing globalization of the legal world. First, more than ever, with the same issues facing many courts throughout the world, the discussions and equivalent legal debates are becoming more and more similar. This can be partially attributed to the advances in global communications and contacts. In addition, with this increasing transmission of news and information across borders, potential litigants are made more aware of the results of litigation in a certain jurisdiction and may see them as encouragement to pursue similar causes in other countries.

A second factor leading to the globalization of the judicial world is the links between national human rights guarantees and such international human rights documents as the United Nations Covenants on Civil and Political[5] and Economic, Social and Cultural Rights.[6] International human rights law has become a kind of "common denominator" of understanding for judges interpreting national or regional human rights documents such that national

4. Justice Claire L'Heureux-Dube, Address at the Courts First International Conversation on Enviro/Genetics Disputes and Issues, EINSHAC (July 1, 2001).

5. *International Covenant on Civil and Political Rights*, G.A. Res. 2200A (XXI), U.N. GAOR, 21st Sess., Supp. No. 16, at 52, U.N. Doc. A/6316 (1966).

6. *International Covenant on Economic, Social and Cultural Rights*, G.A. Res. 2200A (XXI), U.N.GAOR, 21st Sess., Supp. No. 16, at 49, U.N. Doc. A/6316 (1966).

judges in a certain jurisdiction turn to the interpretation of human rights norms in another jurisdiction as persuasive authority.

A third factor leading to the growing internationalization of the judiciary is the advancement of communication technology. With the existence of computers and electronic databases, access to decisions in a broad range of jurisdictions is possible. The Supreme Court of the Philippines, as part of its Action Program for Judicial Reform (APJR), has launched what it calls the Court Administration Management Information System (CAMIS) which is developing a publicly accessible and comprehensive database of all cases under the jurisdiction of the lower courts, including the tracking down of their current status.

A fourth contributor to the increasing internationalization of the judicial world is the growing personal contact among members of the judiciary from different countries. Meeting face to face in conferences, building relationships, and sharing ideas between judges and lawyers from different jurisdictions is bound to improve and refine the process of judicial globalization.

At the same time, the Honorable Claire L'Heureux-Dube pointed out that though the solutions of other countries or of the international community may be useful, foreign reasoning should not be imported without sufficient consideration of the context in which it is being applied. Solutions in one jurisdiction may be inappropriate elsewhere due to political and social realities, values, and traditions which differ across borders, regions, and levels of development. This is not to say that it would not be useful to look to decisions from jurisdictions where the context is different. She stressed that "Cross-pollination helps not only when we accept the solutions and reasoning of others, but when we depart from them, since even then, understanding and articulating the reasons a different solution is appropriate for a particular country will make for a better decision."

As a result of the expanding reach of legal and judicial globalization, the literature, the curricula of law schools, and mandatory continuing legal education programs have become more comprehensive, including international human rights, intellectual property, cyberspace and e-commerce, biodiversity, trans-national organized crimes and law enforcement, international arbitration, immigration and citizenship, extradition, and others. Professor Anne-Marie Slaughter of Harvard Law School opined that "modern judges should see one another not only as servants or even representatives of a particular government or party, but as fellow professionals in a profession that transcends national borders."[7]

7. Anne-Marie Slaughter, *40th Anniversary Perspective: Judicial Globalization*, 40 VA. J. INT'L L. 1103 (2000).

III. INTELLECTUAL PROPERTY RIGHTS AND PIRACY

Few present here may be aware that in the Philippines, we have been annually celebrating Intellectual Property Rights Week since 1992. With the proliferation of pirated products peddled and bought with impunity in some of our shops, it is evident that a number of my countrymen are not aware of what an intellectual property right or IPR is or if they knew, would rather ignore this in view of the lucrative trade in prohibited commodities. I am inclined to believe that such may be the situation in many other countries.

In simple terms, IPR connotes that: authors have copyrights; scientists and inventors have patents; and commercial firms have trademarks, service marks and trade names. Such terms may be alien to the uninitiated. Even less are aware of the related rights enjoyed by artists, performers, producers of phonograms, and broadcast companies.

There can, however, be no doubt that the last decade has seen the metamorphosis of IPR as a mere instrument of protection to that of an active agent of development and progress. Nonetheless, if we look beyond IPR as an "instrument of protection" or "an active agent of development or progress," we will discover that the main office of IPR is to celebrate or define man's genius or originality and, subsequently, to protect it. At times, these two terms may overlap, a fact Arthur Koestler duly acknowledged when he said, "The principal mark of genius is not perfection but originality, the opening of new frontiers." Others, like Johann W. Von Goethe, believe that nothing in this world is original and goes on to say that "everything has been thought of before, but the problem is to think of it again." In other words, to IPR critics like the eminent Dean William R. Inge, originality is nothing but "undetected plagiarism . . . the fine art of remembering what you hear but forgetting where you heard it." One thing remains clear. IPR is a direct consequence of creative intelligence and, whenever its product is inherently beneficial or may be developed for the common good, the protection of the creator's right must be ensured.

Considered as a "non-human right" because it is not enshrined in the Universal Declaration of the Human Rights of Man[8], IPR is a concept borne of exigency, evolving as it did from the increased commercial interaction among nations and spurred by the need to place a premium on man's ingenuity. By contrast, the TRIPS Agreement, or the Agreement on Trade-Related Aspects of Intellectual Property,[9] sets the dimensions within which these commercial rights can be demanded and preserved in accordance with a pre-determined universal

8. *Universal Declaration of Human Rights*, G.A. Res. 217A (III), U.N. GAOR, 3d Sess., U.N. Doc. A/810 (1948) [hereinafter UDHR].

9. Agreement on Trade-Related Aspects of Intellectual Property Rights, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization [hereinafter WTO Agreement], Annex 1C, Legal INSTRUMENTS – RESULTS OF THE URUGUAY ROUND vol. 31, 33 I.L.M. 81 (1994).

consensus. At the core lies the enforcement of IPR, which is all that really matters as far as a holder of an IPR is concerned.

I believe, however, that the TRIPS Agreement is less a product of necessity than of convenience. Before its advent, IPR was already being protected and enforced in many countries through several international conventions, some of which date back over a century. This would include the 1883 Paris Convention for the Protection of Industrial Property[10], the 1886 Berne Convention for the Protection of Literary and Artistic Works[11], and the 1961 Rome Convention for the Protection of Performers, Producers of Phonograms, and Broadcasting Organizations.[12]

Trade dynamics called for periodic revisions of these cluttered treaties. I understand that for the Paris Convention, the latest changes occurred via the Lisbon Act of 1958 and the Stockholm Act of 1967. In the last 50 years, the Berne Convention has undergone three revisions: the Brussels Act of 1948, the Stockholm Act of 1967 and the Paris Act of 1971. The occasional loose provisions of these conventions were consolidated and a uniform set of remedies was devised which gave rise to the TRIPS Agreement.

Even as the TRIPS Agreement simplified the source of IPR and the reliefs available to a right holder, it also extended protection to rights that have emerged in the global market concurrently with the growth of international commerce, especially in technology-dependent industries. The Berne Convention secured the copyrights of artists, writers, and composers; the Rome Convention covered the related rights of performers, producers of phonograms, and broadcasting organizations; and the Paris Convention allowed inventors to patent their works. Over the years, other areas of concern surfaced, such as the production and distribution of live or still film and live music: information technology, including digital data transfers, computer programs, and compilations of data, telecommunications, and satellite transmission; biotechnology and pharmaceuticals; and designer products. These are, by and large, addressed by the TRIPS Agreement, supplemented by the inclusion of rental rights in the use of computer programs and cinematographic works, undisclosed information or what is commonly known as trade secrets, and control of anti-competitive practices in contractual licenses. Hovering on the horizon is the highly controversial but potentially profitable field of genetic manipulation (GM), which in its embryonic stage is already the subject of dispute.

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10. Paris Convention for the Protection of Industrial Property, Mar. 20, 1883 (amended 1979), http://www.wipo.int/treaties/en/ip/paris/pdf/trtdocs_wo020.pdf.

11. Berne Convention for the Protection of Literary and Artistic Works, Sept. 9, 1886 (amended 1979), http://www.wipo.int/treaties/en/ip/berne/pdf/trtdocs_wo001.pdf.

12. Rome Convention for the Protection of Performers, Producers of Phonograms and Broadcasting Organizations, Oct. 26, 1961, http://www.wipo.int/treaties/en/ip/rome/pdf/trtdocs_wo024.pdf.

In this time of seemingly unlimited access to information, products, and services via the digital highway that is the Internet, IPR holders are wary that their interests may be greatly compromised due to lack of sufficient safeguards along the boundless coasts of global trade. On the other hand, developing country-members are quick to point out that IPR and the conventions protecting them primarily pertain to the developed nations, without necessarily taking into account products and industries endemic to a particular State, as well as the capacity of such country to police its own ranks. The TRIPS Agreement is no exception. In fact, it imposes additional obligations on developing States that are already signatories to the other three conventions, in addition to extending protection to parties to the TRIPS Agreement which are not parties to the other conventions, thus, making the process of creation, infringement, and redress clearly one-tracked.

Still, in terms of enforcement, the TRIPS Agreement by far offers the best possible protection and recourse to any IPR holder. It even devotes an entire portion, composed of five sections and twenty articles, solely to IPR enforcement. Article 41(1) presumes that a member-State has adequate remedial mechanisms to prevent or, at the very least, deter infringement. The procedure must be fair and equitable, fundamental, and cost and time-efficient. In other words, IPR cases are to be handled just like any other dispute applying municipal laws. Therefore, common due process requirements, such as notice, the right to present evidence, and the right to counsel, must be observed.

I underscore the fact that the growing awareness on IPR and the corresponding concern on their protection and implementation are due in large measure to globalization. The TRIPS Agreement itself is a mere product of the Uruguay Round of the General Agreement on Tariff and Trade (GATT), which treats of the more complex and expansive realm of global commerce at both the macro and micro level. The seemingly unfettered business environment is fertile ground for violating or abusing IPR. Hence, enforcing IPR would be mutually beneficial to all members of the international community, but because it is not self-policing, we must ensure that, at the very least, IPR should be effectively and efficiently enforced in our own independent backyards.

A. Where do judges and legal practitioners like us come in?

Many lawyers are aware of the laws pertaining to IPR. They must, however, have a deeper understanding of the provisions of the TRIPS Agreement so that these may be applied with equal force and effect in every State. It is this ideal that must be maintained, not only in hindsight but more importantly, in anticipation of a more complex trade relationship revolving around IPR. The key is enforcement. Any law, however well-crafted and well-thought out, will be useless if it cannot be enforced properly and adequately.

I am proud to say that our government has taken some crucial steps in this direction. Our judges are already being trained through programs designed by the Philippine Judicial Academy and the Departments of Justice and of Interior and Local Government have their own training modules for prosecutors and law

enforcers. It must be noted that since many IPR violations, especially piracy and product counterfeiting, are being committed by or through trans-national criminal organizations, regional cooperation among the different law enforcement agencies must be encouraged, if not vigorously pursued, to cut the source of the problem.

I invite your attention to the Intellectual Property Code of the Philippines (IPCP)[13], which was enacted into law on January 1, 1998, as Republic Act No. 8293. Like the TRIPS Agreement, it unified the Philippines' disparate laws on patents, copyrights, trademarks, service marks, trade or business names, and other IPR. The TRIPS Agreement itself is embodied in the IPCP. It is no wonder, therefore, that the remedies available here would include the same remedies prescribed under the TRIPS Agreement. This is what I was alluding to earlier, about the necessity or desirability of expanding the general provisions of the TRIPS Agreement so that they may find local application.

These substantive laws require appropriate rules of procedure for effective implementation and enforcement. Since the rules do not sufficiently address the problems attendant to IPR violations, the Supreme Court of the Philippines adopted the Rule on Search and Seizure in Civil Actions for Infringements of Intellectual Property Rights in January 2002. The said Rule took effect in February 2002.

The Philippines is also one of the first countries to adopt a law on e-commerce. Our Electronic Commerce Act of 2000[14] specifically makes Internet service providers (ISPs) liable for infringement of IPR, whether directly committed by such ISPs or indirectly by allowing their clients to commit the same. It also penalizes

> piracy or the unauthorized copying, reproduction, dissemination, distribution, importation, use, removal, alteration, substitution, modification, storage, uploading, downloading, communication, making available to the public, or broadcasting of protected material, electronic signature or copyrighted works including legally protected sound recordings or phonograms or information material on protected works, through the use of telecommunication networks, such as, but not limited to, the internet, in a manner that infringes on intellectual property rights.[15]

13. Intellectual Property Code of the Philippines, Republic Act No. 8293 (1998) (Phil.), http://www.chanrobles.com/legal7ipo.htm#INTELLECTUAL%20PROPERTY%20CODE%20OF%20THE%20PHILIPPINES%20-%20PART%20ONE.

14. Electronic Commerce Act of 2000, Republic Act No. 8792 (2000) (Phil.), *at* http://www.chanrobles.com/republicactno8792.htm.

15. *Id.* § 33(b).

My reference to our Intellectual Property Code and E-Commerce Act is a veiled attempt to encourage all of you present here today, people of various ethnic backgrounds, to push for the enforcement of IPR laws within the context of the TRIPS Agreement. This, I believe, is the best, if not the only way to guarantee protection to individual and corporate right holders at the national and international stage. Prosecutors may be urged to make use of the vast resources of their government to enforce IPR whenever criminal sanctions are called for. Judges, for their part, could contribute overwhelmingly to this effort by applying the full force of municipal laws alongside the GATT and TRIPS Agreements in cases involving any violation or abuse of IPR. By doing so, they will be sending a message loud and clear that in their country, IPR is secure and fully protected. This, in turn, will pose a challenge to the rest of the world to do the same in order to preserve the unity of purpose that we are all beholden to uphold.

Another former colleague, Justice Reynato Puno, encapsulates it thus, "intellectual piracy, infringement and unfair competition are global concerns that must be addressed with firm hands by the State. For today, the protection of intellectual property is a cornerstone of economic progress in all civilized countries."[16]

IV. FREEDOM OF EXPRESSION, CYBERLAW, AND E-COMMERCE

Prussian monarch Frederick II once said, "My people and I have come to an agreement which satisfies us both. They are to say what they please, and I am to do what I please." This statement captures two essential facets of what we know now as freedom of expression – the freedom to speak out and the freedom to act. Here in the United States, this freedom is protected by the First Amendment and is considered essential to the vitality of representative government. At the core of its concerns is the protection of expression that is critical of government policies. In the Philippines, this concept is enshrined in our Constitution as Article III, Section 4[17] of the Bill of Rights couched in terms derived from the U.S. First Amendment.[18]

Freedom of speech generally includes freedom of the press. Because it is essential to political activities and religious practices, the exercise of the right of free expression often occurs in association with the exercise of the right of peaceful assembly and freedom of worship. It is also intrinsically related to

16. The Rule on Search and Seizure in Civil Actions for Infringements of Intellectual Property Rights, adopted on January 22, 2002 by the Supreme Court of the Philippines and which took effect on February 15, 2002.

17. PHIL. CONST. art. 3, § 4, *available at* http://www.chanrobles.com/article3.htm. "No law shall be passed abridging the freedom of speech, of expression, or of the press, or the right of the people peaceably to assemble and petition the government for redress of grievances." *Id.*

18. U.S. CONST. amend. I.

academic freedom, at least the aspect that pertains to the right of teachers to express opinions in accordance with their beliefs and conscience and with immunity from dismissal or other penalty.

While life seemed complicated enough with the exercise of these aspects of freedom of expression brought to their outermost limits, we never dreamt of quantum leaps in communications conquering both physical distances and outer space surpassing even the fantasies of science fiction. With the advent of electronic media, instantaneous communication across the globe is now possible. People with ideologies and political, educational, and religious messages have discovered new forms of media at their fingertips with which to convey these to a broad, mass-based and relatively anonymous audience.

For, like it or not, we stand dazzled by the bewildering possibilities opening up before us with the unlocking of cyberspace, a hitherto uncharted territory. With virtually no maps, signposts or warning signals, we dare to cross over and explore virgin terrain. Marshall McLuhan, the communications guru had, with unusual prescience, predicted in the mid-1960s that with the rise of electronic media, "we have extended our central nervous system itself in a global embrace." His notion of a "global village" has come to pass. Hence, such an information environment "compels commitment and participation. We have become irrevocably involved with, and responsible for each other."[19] Indeed, we have become in a very real sense our "brother's keeper."

Without cartographers altering the physical metes and bounds, the latitudes and longitudes and the highs and lows of the earth's topography, some age-old barriers have been practically obliterated, great distances breached and frontiers pushed farther through globalized communications. Even as the expansion and development of radio and TV have continued unabated, the outmoded assumptions and blueprints are now undergoing drastic overhauling in light of the convergence of modern technologies and the giant strides being made through the conquest of cyberspace. Whereas radio and TV used to be beamed to a largely anonymous audience, the magic of cyberspace now makes it possible to reach and address a relatively identified broad, mass-based target audience. To quote a hard-nosed observer:

> With convergence, we have seen the traditional copper-wired telephone become a wireless handy device and metamorphosed into a combination of a digital still or video camera, a Personal Digital Assistant (PDA) or even a micro-computer or is it now a handheld or 'wearable' television and

19. DAVID CROTEAU & WILLIAM HOYNES, MEDIA SOCIETY: INDUSTRIES IMAGES AND AUDIENCES (2003) (citing MARSHALL MCLUHAN & QUENTIN FIORE, THE MEDIUM IS THE MESSAGE: AN INVENTORY OF EFFECTS (1967).

> radio? A few years back there were developments of a disposable phone.[20]

Most of my audience here, students and faculty alike, I am sure, use the internet as a handy research tool. Gone are those days when we used to stay up in the library of Maxwell Hall, banging away at a manual, and later, an electric typewriter and producing carbon duplicates. Now with a click of the mouse, a student can have access to infinite resources surpassing even his professor's reference materials. The rest of you have surely utilized the internet as a social vehicle, using for instance, e-bay, friendster/ICQ, and peer to peer communication. Beyond this boon to scholars, it has been stated that: "The potential benefits of the internet are numerous and range from simple improvement of communications, to a revolution in commerce and an increased potential for expression and democratic involvement of citizens in some other level of political engagement."[21]Thus far, we have been dealing with that aspect of globalized communications which has made instantaneous interaction over great distances possible, thus changing the role of geography in our lives. However, a dimension fraught with legal implications is the content of the communication. It has been pointed out, and with reason, that

> much of the concern to date has revolved around the threats to privacy, intellectual property rights, the prospect of universal defamation and the implications for national tax collection. Additionally, there are concerns about the security of network systems and unauthorized access and denial of service attacks, concerns about the availability of indecent, obscene and racist content, concerns about the use of computer technologies for traditional property offences such as theft, fraud , threatening hate speech and online stalking. There are further fears about the disregard of national legal sensitivities, whether about contempt of court, gambling or otherwise.[22]

How many of us have cringed at the unexpected and sudden sight on TV of beheadings of hostages, carnage in civilian areas, and more recently the eighty-seven-second video footage showing the massacre of over three hundred schoolchildren, teachers, and parents by masked gunmen demanding independence for Chechnya at the North Ossetia School in southern Beslan? To be sure, we would rather dwell on the major international events brought to our living rooms or bedrooms by satellite such as the recently-concluded Athens Olympic Games viewed by hundreds of millions of sports enthusiasts

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20. Charlton Jules Romero, Lecture Notes, St. Scholastica's College (2004) (on file with author).

21. THE INTERNET, LAW AND SOCIETY (Yaman Akdeniz et al. eds., 2000).

22. *Id.*

living in different time zones. While we do not have the figures of the spectators of this event, we do know that the Sydney 2000 Olympic Games were viewed by an estimated 3.7 billion people in 220 countries. CNN's network broadcasting via 23 satellites reaches more than 800 million people in 212 countries, not to speak of those hooked up via CNN's websites.[23]

Faced with the acceleration of commercial and social interaction over a broad expanse of the globe brought about by non-traditional, high-tech gadgets and instruments, the formal institutions regulating human conduct operating within territorial boundaries, like law, had to grapple initially with the unknown. Thus, in order to curb possible excesses and avert potentially explosive trans-national situations, lawmakers all over the world were called upon to enact appropriate legislation, and judges to familiarize themselves with subjects not covered in law school curricula. More importantly, due to the nature of cyberspace, international negotiations were set into motion which eventually resulted in conventions, treaties, and resolutions binding upon nations ratifying them. This is not to say that it has been possible to contain excesses of cyberspace. As one author succinctly put it:

> The attributes of transnationality, instantaneity and accessibility make national regulation or indeed any level of imposed regulation very difficult to accomplish and enforce.... These difficulties facing regulators are compounded by the fact that there is no overall ownership of the internet. It is made more complex by the convergence of media, creating uncertainties as to which authority should act and which sectoral standards should apply.[24]

In the realm of cyberspace, the task at hand for us lawyers and judges is to identify the subjects of what we may term as "translegal", as opposed to national, regulation appropriate to its safe carriage and conduct. "This would include: transborder or international carriage (including technical-technological standards); transborder access; privacy; encryption; domain names; content labeling/rating; international network hotlines and copyright."[25] A mastery of the laws governing intellectual property rights would be useful for this purpose, especially in the area of dispute resolution.

This leaves to the mechanisms and infrastructure at the national level the job of, among others:

> [E]nsuring compliance with agreed international principles; criminal law in respect of illegal content, e.g. paedophiliac

23. *Id.* at 7.

24. *Id.* at 9.

25. THE INTERNATIONAL DIMENSIONS OF CYBERSPACE LAW (Teresa Fuentes-Camacho ed., 2000).

> material, terrorist material and racial/ethnic/religious hatred material consistent with established principles of international law; working on schemes to regulate harmful content, including industry self-regulated codes, content rating schemes tailored to national cultural mores and hotlines; encouraging local language content on cyberspace; community education on the use of cyberspace and facilitation of local access to cyberspace.[26]

The rapid rate of technological change over the past decades, especially in the sphere of information management and exchange, and in communications systems, especially in cyberspace, should give us an idea of the necessity, if not the urgency, of looking ahead. For intellectual as well as practical considerations, the legal profession must plan for change in order to ensure that the benefits to be gained will be maximized.

It is a truism that technology or, more precisely, the use of technological tools will continue to induce extraordinary shifts in otherwise ordinary aspects of life. Law and legal practice are no exception. Evidently, because the legal profession has lagged behind other fields in adapting to improvements in technology, accelerated transformations entailing the espousal of such changes are likely to have a tremendous effect on traditional legal and judicial practice.

One such transformation that will most likely occur is what has come to be known as "dematerialization." This concept connotes a substantial removal of the tangible barriers to communication among the courts, the court users, and the general public. I would venture to say that the practice of telecommuting is rooted in this notion. In essence, however, it requires more, namely, a movement from our physical space to cyberspace, a shift from a document-dependent system to paperless courts. In many jurisdictions, this is now a reality. The benefits that may spring from such a transition are immediately apparent.

In the Philippines, our e-commerce law, namely, Republic Act No. 8792 or the Electronic Commerce Act of 2000,[27] was carefully scrutinized by the Supreme Court for the purpose of introducing appropriate changes in our Rules of Court. Such changes were reflected in the Rules on Electronic Evidence, adopted by the Court on August 1, 2001. With developments in information and communication technology, cases can now be initiated by a prospective litigant and pleadings filed electronically by lawyers from places other than the courthouse. As regards cost-effectiveness, equipping the courts with the latest hardware may seem too enormous an undertaking, considering the magnitude of work to be done, including training the end-users on how to maximize the utility of computers as "office managers." Fortunately, the existing downward

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26. *Id.*

27. *See* Electronic Commerce Act, Republic Act No. 8792, http://www.chanrobles.com/republicactno8792.htm.

trend in the average cost of IT facilities will persist, making such an ambitious project less challenging. Moreover, no price is steep enough for the sake of efficiency and the speedy disposition of cases or for ensuring a more effective system of case and court management.

The purpose, if not the result, of this entire exercise is what has come to be referred to as "paperless courts." Under this setup, printed documents that usually tie up court operations will be a thing of the past. Thus, the administration of justice will not only be streamlined toward greater efficiency, but with thousands of trees saved as a direct consequence of the reduced consumption of paper, the court will also fulfil its constitutional and natural obligation to align its operations in harmony with nature and the environment.

V. ROLE OF JUSTICE SYSTEM IN ECONOMIC DEVELOPMENT

Commerce and industry are commonly recognized as the keys to unlock the doors of national prosperity, but they are by no means the only vehicles of sustainable development. In the case of the Philippines, there is still a need to understand our political history in order to see the complex relationship between the law and its objects, including foreign nationals, and how the courts intervene in resolving conflicting interests. The quality of justice meted out, as well as the speed by which it is made, is vital in measuring the soundness and viability of economic policies.

History shows violent swings in our nation's economy due in large part to our dependence on a stable foreign reserve. As the exchange rate steadily pulled the value of the peso down in the last quarter of a century, trade focused and continues to focus on export-oriented goods and services, with overseas Filipino workers generating the highest revenues. The widening trade imbalance, however, reveals the futility of this effort.

The 1997 crisis was a major wake-up call for all of us. It taught everyone not to be complacent amid progress brought about by greater global market access and concentrate instead on developing and supporting indigenous industries. This would necessarily require a strong political will and a stable social order.

Since time immemorial, the law has been utilized for the primary purpose of maintaining this order. If order in civilized society breaks down, one can easily expect chaos that would rise to the level of barbarism. Surely, nobody wants to relive the Dark Ages. To achieve true harmony, the law must co-exist with an unshakable mechanism for enforcing or interpreting concomitant rights and duties. This is where an effective and efficient justice system makes its presence felt – to resolve disputes that may erupt between and among the people, the lawmakers, and the law enforcers regarding a law's content, application or manner of execution.

The role of the justice system in economic development is no different from its general utility. To put it plainly, peace, a direct result of "order," fosters a climate conducive to progress and prosperity. A closer peek into the past will demonstrate parallelisms of relative serenity in the Renaissance and in

this century. Amid the random periods of turmoil in these two eras sprang cycles of highs and lows – more highs than lows, actually – in the various economies of the world. In the early days, such flourishing was the unexpected, yet, inevitable result of experiments in the political and economic theories of such brilliant thinkers as Jean Paul Sartre, Niccolo Machiavelli, and Immanuel Kant. Developments in modern thinking would never have thrived in an atmosphere of social uncertainty, if not instability.

By contrast, in the past century that has seen two major wars, with most systems of socio-political and economic import installed in practically every corner of the globe, human creativity was pushed and continues to be pushed to the limit. Wars betray man's impotence to settle differences within the confines of man-made laws. Yet, before, between, and after these armed conflicts, when the social order was operative, human creativity took center stage and made our lives more comfortable with mind-boggling breakthroughs in the physical sciences. Discoveries in science and technology, medicine, radio and communications, transportation, and electronic data processing, to name just a few, became the standards by which human progress was measured. Hence, those who ushered in this second Industrial Revolution witnessed a marked enhancement in their way of living. The fact that the developed nations control the most advanced technological tools is no coincidence. Again, I daresay that all these developments would not have been possible had no reliable and independent justice system enforced the proper legal conventions.

Consequently, citizens who are confident in their political leaders and in the courts are spurred toward improving themselves in all aspects of life. In the process, they become more efficient, more productive even if more competitive in ways that would never occur in a hostile environment.

An efficient and effective judiciary, enjoying the public's trust and confidence, reflects the state of the country and the resolve of its leaders to propel the economy forward. A stratospheric crime rate would naturally discourage business and investment. The inability of the courts to protect commercial interests would also defeat economic policies, however sound they may be. Inversely, when crime is kept at a minimum, people, in general, and business people, in particular, see the law at work. It is a situation where the law offers statutory protection, the authorities ensure physical security, and the courts balance all the competing interests in the community to serve the social order. Reforms underway in our judiciary through the efforts of the Chief Justice would inevitably lead to a rosy socio-political climate instrumental in initiating the necessary economic reforms. One of these is the Supreme Court's pursuit of alternative modes of dispute resolution to decongest the dockets of the courts.

VI. ARBITRATION

Lord Woolf once said, "Litigation is to be avoided where possible, should be more cooperative and less adversarial, shorter and less complex, more affordable, more predictable, with costs more proportionate to the value of the

claim." Our own Chief Justice Davide, for his part, once said that, "It is high time that we ... build upon our ... traditions to create a Filipino judicial philosophy that seeks to end disputes with the least expense in terms of time, money, and emotion, and with the most just resolution. The time is ripe for mediation."

Clearly, arbitration and other alternative modes of dispute resolution like negotiation and mediation are to be preferred to any other course of action because they are cheaper and provide a faster resolution of disputes. Being an advocate of alternative modes of dispute resolution and being an arbitrator myself, I fully concur with this suggestion. In the Philippines, the law on Arbitration in general is found in the Civil Code of the Philippines. In 1986 more specific rules on arbitration in the construction industry applicable to domestic disputes were enacted in Executive Order No. 1008.

As regards arbitration of commercial disputes involving parties coming from different jurisdictions, the Philippines, as with other countries, fell back on the Model Law on International Commercial Arbitration adopted by the United Nations Commission on International Trade Law (UNCITRAL) on June 21, 1985, and recommended for approval on December 11, 1985.[28] The product of the minds of the best legal luminaries in commercial law in the world working intensively for two decades, it sought to harmonize the national laws on arbitration and, in the process, facilitate cross-border or international business transactions. Among other topics, the Model Law covers the essential elements of an arbitration agreement, the composition and jurisdiction of the arbitral tribunal, the conduct of the arbitral proceedings and enforcement of the tribunal's award. In case of ambiguity, the covering report of the UNCITRAL's Secretary General is available for guidance and reference.

Arbitration truly blossomed in the final decades of the last millennium. This was the time when international commercial arbitration gained worldwide acceptance as a means of resolving disputes arising from growing global trade. Due in large measure to this development, municipal arbitration laws have been made up-to-date in most jurisdictions. In the Philippines, Republic Act No. 9285 was recently passed, otherwise known as the "Alternative Dispute Resolution Act of 2004".[29] With the Model Law attached as an appendix, the Act promotes the use of such alternative dispute means of settlement as mediation, conciliation, and arbitration to expedite the dispensation of justice without sacrificing fairness and impartiality; in the long run, parties to international commercial disputes find that such procedures cut down costs too. In the Philippines, courses on ADR have become part of the evolving curricula of progressive law schools and such institutions as the Asian Institute of Management (A.I.M.) or professional organizations like the Personnel Management Association of the Philippines (PMAP).

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28. Model Rule on Commercial Arbitration, U.N. Doc. A/RES/40/72 (1985).

29. Alternative Dispute Resolution Act of 2004, Republic Act No. 9285 (2004) (Phil.), *at* http://www.chanrobles.com/republicactno9285.html.

The incisive assessment of the International Court of Arbitration, which was established way back in 1923, still holds true:

> With the gradual removal of political and trade barriers and the rapid globalization of the world economy, new challenges have been created for arbitration institutions in response to the growing demand of parties for certainty and predictability, greater rapidity and flexibility as well as neutrality and efficacy in the resolution of international disputes.

What used to deter litigants from having recourse to international arbitration was the nightmarish prospect of turning to domestic courts for the enforcement of the arbitrator's decision and, thus, going through the process of trial and presenting evidence all over again. With the approval in 1958 of the United Nations Convention on the Recognition and Enforcement of Arbitral Awards,[30] otherwise known as the "New York Convention," later ratified by the Philippine Senate, the signatory countries laid down the procedure which should be observed in the appreciation of and compliance with decisions or awards rendered by tribunals in international commercial disputes.

Under the Convention, if an arbitral award has been rendered in accordance with the parties' arbitration agreement, the courts of the country in which it is being enforced are obligated, as a matter of comity and goodwill, to give it full faith and credit. Under our Republic Act No. 9825, a regional trial court has to confirm a foreign arbitral award by requiring the party asking for its enforcement to file the original or authenticated copy of the award and arbitration agreement. It has to be proved, moreover, that the country in which the foreign arbitration judgment was made is a signatory to the New York Convention. However, if the foreign country is not a party to the New York Convention, provisions should nonetheless be made by our courts for the award to be accorded liberal treatment on grounds of comity and reciprocity. As a result of the confirmation, foreign arbitral awards shall henceforth be treated and enforced in the same manner as final and executory decisions of courts of law of the Philippines. The writ of execution can be immediately issued by the court and enforced by its sheriff, thus giving all parties concerned much savings in terms of time and money.

The use of arbitration to resolve a variety of disputes forms a significant part of the system of justice on which our societies rely for a fair determination of legal rights. Arbitrators, therefore, undertake serious responsibilities to the public, as well as to the disputants. Those responsibilities include important ethical obligations. Since 1977, arbitrators such as me have been guided to a large extent by an Ethics Code drafted by the American Arbitration Association in cooperation with the American Bar Association. The AAA adopted on

30. United Nations Convention on the Recognition and Enforcement of Arbitral Awards, June 10, 1958, 21 U.S.T. 2517, T.I.A.S. No. 6997, 330 U.N.T.S. 38.

March 1, 2004, a revised Code of Ethics for Arbitrators in Commercial Disputes. Such revision of the 1977 Ethics Code was necessitated by legal developments and heightened international trade transactions. Some of the substantive changes include establishing a presumption of neutrality, independence, and impartiality on the part of all arbitrators, including party-appointed ones; in the latter's case, there is now a duty on the part of the arbitrator to disclose if he or she will be acting in a neutral or non-neutral capacity; arbitrators without exception are now required to disclose interests or relationships likely to affect their impartiality or which might create an appearance of partiality; communications with the parties and other arbitrators are hedged in by guidelines; and in addition to imposing impartiality and independence standards that form the basis of the presumption of neutrality, every arbitrator is obligated to determine his or her competence and availability to serve in the case.

VII. CITIZENSHIP

The United States has always prided itself on being the grandest melting pot in modern times. It is the land of milk and honey, the bastion of democracy. It conjures images of immigrants, the "huddled masses" from the Old World, crowded in ships slowly passing by the Statue of Liberty. It is a vision that in the last two centuries has not changed much with recent statistics showing 450,000 alien residents being granted U.S citizenship every year. America is so culturally diverse in terms of its citizens' ethnic origins, yet it's openness to strangers has given birth to a nation with a culture that is uniquely cohesive. But nations with strong economies that enjoy a comfortable area-to-population ratio, such as the United States, Canada, Australia, and New Zealand, have in the recent past altered the mindset of people coming from countries plagued by poverty, civil unrest, or protracted wars. No longer do we simply speak of migration; instead, we witness Diaspora, entire peoples willing to take root in any country other than theirs. I am not even speaking of refugees, but people who are capable of fending for themselves in every way. This could pose problems in the host State because of the potential adverse effects of massive human inflow on employment opportunities, utilization of resources, and peace and order.

Despite these developments, however, we have witnessed a trend of leniency in immigration and repatriation. The Philippine Congress, for instance, passed a law in 1995 (Republic Act No. 8171), which eased the requirements for the repatriation of Filipino women who have lost their citizenship by marriage to aliens or due to political or financial needs. Under its Section 2, repatriation may be effected simply by taking the necessary oath of allegiance to the Republic of the Philippines and registration in the proper registry and in the Bureau of Immigration.

On August 29, 2003, our Congress passed Republic Act No.9225, known as the Citizenship Retention and Re-acquisition Act of 2003.[31] Under the law, natural-born citizens of the Philippines who have lost their Philippine citizenship by reason of their naturalization as citizens of a foreign country are deemed to have re-acquired Philippine citizenship upon taking the oath of allegiance to the Republic. They shall, thereafter, enjoy full civil and political rights. This law is a direct offshoot of a 1989 Supreme Court decision where a Filipino who had lost his citizenship was deemed repatriated after he took his oath of allegiance to the Philippines and, therefore, eligible to assume the duties of public office.[32]

Under Article IV, Section 5 of the Constitution of the Philippines[33], "Dual allegiance of citizens is inimical to the national interest and shall be dealt with by law." It took a 1999 decision of the Supreme Court to categorically recognize dual citizenship which "arises when, as a result of the concurrent application of different laws of two or more states, a person is simultaneously considered a national by those states. For instance, such a situation may arise when a person whose parents are citizens of a state that adheres to the principle of *jus sanguinis* was born in a state which follows the doctrine of *jus soli*. Such a person, *ipso facto* and without any voluntary act on his part, is concurrently considered a citizen of both states."[34] Hence, a Filipino born in the United States of Filipino parents is a citizen of both countries since *jus sanguinis* is recognized in Philippine jurisdiction and *jus soli*, in the United States.

VIII. ENVIRONMENT, BIODIVERSITY, SUSTAINABLE DEVELOPMENT

No other issue in contemporary times has so graphically demonstrated the utter dependence of nations on each others' linked-arm cooperation in order to survive as matters affecting nature's despoliation. Yet, in spite of the gravity of the problems facing us as a species, despite the complexity and enormity of the proposed solutions, no single individual, country, or race can be held accountable for bringing it about. What is even more frustrating is that compared to nature, we are expendable. At the end of the day, after all studies have been exhausted, after all our puny attempts to undo the damage have been made, we realize that nature is perfectly capable of healing itself without our help if only we would give Mother Nature some breathing space. But our unique humanness makes standing still an impossible feat. It seems almost paradoxical that while we strive and strain to shape our environment to reflect the advancements in various facets of our lives, we are unwittingly destroying the very fountainhead of our continued existence.

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31. Citizenship Retention and Re-acquisition Act of 2003, Republic Act No.9225 (2003), *at* http://www.chanrobles.com/republicactno9225.html (Phil.).

32. Frivaldo v. COMELEC, G.R. No. 87193 (1989) (Phil.).

33. PHIL CONST, art. 4, para. 5, *available at* http://www.chanrobles.com/article4.htm.

34. Mercado v. COMELEC, G.R. No.135083 (1999) (Phil.).

I do not intend to sound so grim. Saving our environment, or at least preserving its remnants, is possible. But in the Pacific Rim, which is home to at least seven of the seventeen globally identified mega-diverse countries, including the United States and the Philippines, as well as half of the world's population, the warning bells ring ominously. This is why we are collectively obligated to address the environmental risks to which our air, water, and landunder the ground and under the sea, are wantonly exposed.

The naturalist Margaret Mead said it best. "We are living beyond our means. As a people, we have developed a lifestyle that is draining the earth of its priceless and irreplaceable resources without regard for the future of our children and people around the world."

Quite a number of studies have been made showcasing the environmental concerns of diverse groups. To these may be added the population problem insidiously eroding the innards of every major city. We simply cannot discount the economic principle of supply and demand. It is our demand that creates the need which primary producers are all too willing to satisfy, but it is our indiscriminate use of these products that creates the waste that will eventually obliterate their source, and the more the people, the greater the demand. We must not forget that we are on top of the food chain. If we allow the indiscriminate destruction of nature's blessings, we ourselves will be devoured. How true has it been said: "There is enough for man's need, but not enough for man's greed!"

The Pacific Rim holds some of the greatest natural treasures on earth. Yet the region is also among the hottest of the hotspots in the world. The dictum "abundance breeds waste" finds no better manifestation than in the ecological crisis in our region. In less than a century, we have depleted our marine, forest, and water resources, and we have spread toxins that poison these same resources and threaten the continued survival of all plant and animal life.

In fact, in the last three decades, timber exports have dramatically increased in the Philippines, Indonesia, and Malaysia, generating substantial foreign currency revenue for their respective governments but at a heavy cost to the forest reserves. The seas have not been spared. In the Sulu-Celebes Marine Triangle, nefarious fishing practices employing explosives and poison are destroying some of the richest coral formations in the world. Most disturbing is the depletion and contamination of our water resources. We are informed that 97% of all the waters in the world is salty, 2% is locked in glaciers, and only 1% is available as freshwater in our streams, rivers, and aquifers. The effects of pollution and contamination on freshwater and marine systems are such that we have a grim scenario where the next global war will be fought over control of a state's water supply, not of its sovereignty per se.

Most Asian cities are weighed down by a thick cloud of toxic particles emitted by motor vehicles and factories which are, ironically, symbols of progress. Health and productivity repercussions are quite obvious. In China alone, about 178,000 people prematurely expire each year due to respiratory illnesses. Not only is air pollution deadly, it is also costly. In this regard, the

World Bank estimates the cost of healthcare and its negative effects on productivity in Metro Manila alone to be between $200 to $300 million annually. This fact probably provided some of the impetus for our Congress to finally pass the Clean Air Act in June 1999,[35] but our judiciary has yet to render decisions interpreting its provisions.

There is no doubt that bad air is largely responsible for the thinning of the ozone layer and its greenhouse effect. In the past, climatic changes have been barely perceptible. The lack of global alarm led to complacency. Lately, however, the destructive power of nature has been abnormally unleashed, leading to unprecedented atmospheric fluctuations giving life to such terms as "*el niño*" and "*la niña.*" I know you agree with me that there is nothing adorably childlike about heat waves, harsh winters, and flash floods.

It is ironic that the richest and most diverse region in the world, in terms of natural resources, is now almost scraping the bottom of the barrel. Indeed, much sooner than we realize, the full impact of global warming and marine and forest resource depletion will show itself, and our children will inherit a parched earth incapable of sustaining life as we know it today.

What I have cited thus far is humanity's losing battle against the degradation, despoliation, and denudation of earth's natural resources abetted by the neglect and wilful depravity of man himself which has unhinged the balance of Nature's ecosystems.

At the same time, within memory are the so-called "accidents" that wreak havoc on seas and forests such as the oil spills that pollute waters and kill all marine life within their perimeters; the forest fires that rage for weeks on end defying all attempts at containing them by water, chemicals or mechanical ways of isolating the area by digging trenches around the circumference; the oil wells that feed fires seemingly gone berserk and the inundations that leave incalculable destruction of lives and properties in their wake. Sadly, the resulting pollution and devastation on land and space leap across geographical boundaries which have seemingly been obliterated, impelling the leaders of the affected areas to join hands in desperate cooperation.

A. What can we do or contribute to the global effort of saving the environment?

The initial step is recognition and awareness. Conferences have been held all over the world to identify the vital ecological issues and problems. But beyond such intellectual excursions into the realm of the possible, we, as lawyers and judges, must face the challenge of determining what active role we must play in enhancing concerted efforts to preserve and promote sustainable development in the wake of globalization.

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35. Clean Air Act of 1999, Republic Act No. 8749 (1999) (Phil.), *available at* http://www.chanrobles.com/philippinecleanairact.htm (last visited March 25, 2005).

Our lawmakers, in the exercise of their authority and powers, must take the initiative to harness the full force of the police power of the State or the power of promoting the general welfare in regulating the people's exercise of their rights and liberties. In doing so, the environment gains a mighty ally, if not a savior, in Government. In the Philippines, the State forged a pact with nature when the Constitution provided as a policy in its Article II, Section 16[36], that "[t]he State shall protect and advance the right of the people to a balanced and healthful ecology in accord with the rhythm and harmony of nature." A communal arrangement of "sharing" environmental legislation may also be established in certain regions so that fresh and practical ideas that may have local application can be fully exploited.

We will also greatly benefit from a uniform set of procedural rules governing cross-border or trans-national environmental controversies. Any controversy involving environmental issues can be resolved through a collective effort, without necessarily resorting to extraneous mediation bodies.

Many countries have a sufficient legal framework for environmental protection and sustainable development. The Philippines, for one, may arguably have the most sophisticated set of Environmental Laws in our region. Yet, this has not prevented its terrestrial and marine resources from being depleted and contaminated to their present crisis proportions. The point I wish to emphasize is that laws alone are not enough. For a law to be effective, the reason behind it, the *ratio legis*, or the social good the law seeks to protect or advance, must be actively promoted. Indeed, the duty to promote the social end is a prime responsibility of everyone who aspires to live a healthy and productive life amidst a pristine environment.

Even as each can contribute in modest but meaningful ways, it should not be forgotten that there are institutional mechanisms that infuse existing law with dynamism and vigor. The courts, whether international or domestic, are confronted with the daunting task of not merely concretizing the abstract philosophy and interpreting the letter of the law but of achieving the social purpose through its creative and imaginative application.

For instance, in dealing with an imminent or ongoing ecological threat in an adjacent state but whose effects transcend the common border, it may be senseless for the courts to inhibit themselves by drawing an imaginary "demarcation line" beyond which it dare not stray. Herein is a challenge worthy of the best judicial minds. Can the law find a way of legally skirting the territoriality doctrine? Let us not forget that the citizenry look to the judiciary to wield its traditional clout and apply tried and tested sanctions. The notion of the judiciary evolving into a "profession that transcends borders" may finally be realized as brethren on either side of the affected area, taking cognizance of their common problem, make pronouncements complementing each other. Thus, globalization of the judicial community may gradually materialize. The

36. PHIL. CONST. art II, § 16, *available at* http://www.chanrobles.com/article2.htm.

Executive, in turn, may be challenged to employ its "arsenal" of weapons through negotiations, diplomacy, and pressures at the highest levels.

Allow me to cite an instance where the Supreme Court of the Philippines, faced by a seemingly insurmountable legal obstacle of procedural law, dared to be innovative and, by invoking a novel principle of inter-generational responsibility, established a resounding precedent to promote the "rhythm and harmony" of Nature as enshrined in the Constitution.

At the height of wide-scale logging in the country's virgin forests ten years ago, forty-three children filed a class action against the Philippine Government for the destruction of their natural heritage. The suit was initially ignored, even scoffed at, in legal circles. It did not even touch first base in the trial court, which dismissed the case outright without even a hearing on the ground that the children did not possess the legal personality to file the suit on their own behalf, much less on behalf of generations yet to be born. The children went to the Supreme Court via a special action of certiorari in a case entitled *Oposa. v. Factoran*[37] In a seminal and widely acclaimed decision promulgated on July 30, 1993, the Supreme Court disregarded the procedural question, recognized the children's legal standing to sue on their own behalf and on behalf of others similarly situated and even those of generations yet unborn and gave due course to and granted the children's petition. The Court reasoned out that all people have a responsibility to care for the vital life support systems of the Earth, not just for this generation, but also, and most especially, for future generations. The mandate of the Constitution to protect and advance the right of the people to a balanced and healthful ecology in accord with the rhythm and harmony of nature imposes this inter-generational obligation.

Unknown to many, this case spurred the drive against forest destruction in the Philippines. During the pendency of the case, our Executive Branch banned all logging activities in the country's virgin forests, which are now under the legal protection and coverage of our law on the National Integrated Protected Areas System. In its effort to protect the seas and the coral reefs, the Supreme Court of the Philippines likewise struck a hard blow against cyanide fishing. In its decision in *Tano. v. Socrates*, the Court upheld the power of local governments to pass ordinances which, in effect, curtailed the market for fish caught with the use of sodium cyanide.[38]

Another important component of environmental law enforcement and protection is monitoring. Our judiciary must be constantly apprised of the true environmental status of the region so that it can support the measures and mechanisms for maintaining adequate preparedness before any natural catastrophe or crisis overtakes it.

37. G.R. No. 101083 (1993).

38. Tano v. Socrates, G.R. No. 110249 (1997).

IX. TRANSNATIONAL ORGANIZED CRIME

No discussion on the legal challenges of globalization will be complete without mentioning crime, particularly transnational organized crime (TOC) as committed by transnational organized crime groups (TOCGs). The final formulation of the definition of TOCG which evolved after lengthy discussions of INTERPOL at the First International Symposium on Organized Crimes in France in May 1988 runs thus: "Any group having a corporate structure whose primary objective is to obtain money through illegal activities, often surviving on fear and corruption." Obviously, this definition, as simplistic as it is, has become passé as it finds application only to the ordinary international criminal syndicates operating for profit within a circumscribed area.

X. TERRORISM

With particular reference to terrorist groups that operate in the context of global and regional conflicts, the usual categorized boxes are no longer relevant or pertinent. Faceless, nameless, and certainly not motivated by profit, they are undoubtedly well-funded; highly organized with their operations meticulously planned by their leaders who have placed themselves beyond the reach of international law; disdaining the orthodoxies of military engagements; utilizing airspace to target strategic areas with maximum global impact at minimal cost to their operators and setting up training centers world-wide to educate their followers in the employment of the most sophisticated weaponry to their advantage. Exalting martyrdom, they hold hostage even the most powerful nations which have to be in a constant state of high alert and vigilance knowing full well their vulnerabilities to attacks that can take place any time anywhere.

What will forever remain a grim reminder of the potent capabilities for destruction across borders of these *sui generis* terrorist groups is their unprecedented 9/11 attack on the World Trade Center Towers in New York City in 2001. Having transmogrified into more deadly entities, these modern-day TOCGs dare governments to track them down in their lairs and predict their next moves. Vital to their existence is the vast network of their faceless leaders, financiers, and loyal followers with tenacious tentacles encircling the globe.

The Philippines, on its part, has been engaged in a continuing battle to ferret out terrorists believed to be members of the Jemaah Islamiyah (JI) network, the Indonesian-based group reputed to be the Southeast Asian arm for Osama Bin Laden's *al-Qaida* international terror network. According to the International Crisis Group, an independent Brussels-based research organization, Mindanao, the southern island of the Philippines, has become a training ground for a new generation of recruits that could strike anywhere in the world, even as they maintain connections with local Muslim insurgents like the Moro Islamic Liberation Front (MILF) which has been waging a twenty-six-year separatist rebellion against our government. Relatively scant attention has been given to TOGCs and terrorist groups by our leaders due in large measure

to their preoccupation with such domestic problems as the imminent financial crisis, poverty, and unemployment, peace and order, and over-population. This has been compounded by the traditional notion that crime prevention lies within the purview of domestic law enforcement although the administration has not been remiss in setting up Task Forces and special law enforcement groups to cooperate with their international counterparts to contain the spread of terrorism in this part of Asia.

Seemingly powerless to cope with a global menace that defies traditional rules of international law, normally complacent countries now resort to exchanging intelligence information or prisoners or detainees on their "Wanted List" and exerting international pressures and sanctions within a political, diplomatic, and economic context.

The ordinary TOC, much like terrorism, is a serious global threat that has evolved into a sophisticated and even legitimate means of perpetuating criminal activities and shadowy, nefarious operations across borders. It continues to threaten the future and the very existence of every man, woman, and child because of its innate voraciousness. No one is spared, not the Americas, not the European Union, especially not the developing countries and emerging democracies in Asia and Africa. It destabilizes economies and creates a façade of stability and progress to conceal the erosion of the moral fabric of modern society on which it feeds. Globalization and the growing popularity and application of the Internet have made it possible for TOCGs to expand their activities at an alarming rate under a cloak of legitimacy and to establish bases of operations beyond their normal and traditional confines. States with high poverty levels are particularly vulnerable to such incursions because of the staggering amounts these groups are willing to invest in employing offshore managers and in gaining the goodwill of some well-placed corrupt local law enforcers and officials. Many countries fit this profile, including, I must admit, the Philippines.

Turning now to the more manageable aspects of TOCs and TOGCs, international and regional efforts continue unabated in an effort to contain this threat. For instance, in Southeast Asia, the Philippines has sought to fight this war in alliance with its neighbors. In a grand show of regional solidarity, nine Ministers of Interior/Home Affairs and Representatives of ASEAN member countries converged in Manila on December 20, 1997, for the 1st ASEAN Conference on Transnational Crime and signed the ASEAN Declaration on Transnational Crime. The Conference marked the culmination of a series of activities beginning with the adoption of the Naples Political Declaration and Global Plan of Action of November 23, 1994.[39] The signatories to the ASEAN Declaration resolved to confront transnational crime by, among other measures, strengthening each nation's commitment to cooperate in combating TOC,

39. *Naples Political Declaration and Global Action Plan Against Organized Transnational Crime, U.N. GAOR*, 49th Sess., U.N. Doc A/49/606 (1995), http://www.un.org/ga/49/r159.pdf.

encouraging them to assign police attaches and/or liaison officers in each other's capitals to facilitate cooperation, urging the networking of relevant law enforcement agencies in the member countries and expanding the scope of efforts against TOC. These steps, I believe, are necessary and commendable, but without the political will to carry them through, an international or regional defensive effort, much less an offensive one, will flounder in the face of the more focused and organized activities of criminal syndicates.

For some time, Philippine leaders have been aware of the guidelines and policies on the prevention and control of organized crime, judicial independence, extradition, mutual assistance, transfer of proceedings, and treatment of prisoners, among other matters. Unfortunately, there has been a dearth of relevant local legislation on these subjects, and the ones enacted have been fairly conservative, awaiting further laws for their effective enforcement.

On January 15, 1999, however, the Philippine Center on Transnational Crime (PCTC) was created. The establishment of the PCTC was deemed necessary after it was determined, among other things, that: (a) TOC has adversely affected the political, economic, and socio-cultural stability and security of the Philippines; (b) the functions and responsibilities of various law enforcement and related agencies need to be linked, coordinated, and complemented to effectively combat TOC; and (c) the growing sophistication of TOC demands a concerted, synchronized, and focused effort from these agencies, including the judiciary.

In this regard, the PCTC has gone beyond its stated mission of formulating and implementing a concerted program of action for all law enforcement, intelligence, and other agencies for the prevention and control of transnational crime but held fast to its belief in a united and coordinated approach, both domestic and international, to safeguard national security and interest against the menace of transnational crime.

XI. TRAFFICKING IN HUMAN BEINGS

One of the most pernicious activities engaged in by TOCGs is human trafficking. Promoted by highly-organized syndicates operating across borders with the aim of amassing profit through illegal means, it is unique in its viciousness in that it preys particularly on women and children who are exploited mainly for sex or forced labor. In the process, fundamental rights of the victims are violated such as the rights to liberty and security of person; to freedom of movement; to freedom from discrimination; to the highest standard attainable of physical and mental health; to equal protection under the law; to sexual integrity and autonomy; and the right not to be subjected to cruel, inhuman, and degrading treatment.

These rights are all embodied in such international instruments, starting with the first one in 1926 which was the Convention to Suppress Slave Trade and Slavery and the subsequent UN documents which are decidedly broader in scope than slavery, trafficking and forced labor, such as the Universal Declaration of Human Rights of Man; the International Covenant on Civil and Political Rights; the International Covenant on Economic, Social, and Cultural Rights; the Convention for the Suppression of the Traffic in Persons and of the Exploitation of the Prostitution of Others; the Convention on the Elimination of All Forms of Discrimination Against Women and the Convention on the Rights of the Child.[40]

What is so odious in the trafficking of humans is that it not only reduces persons into mere commodities but also because it breeds such other crimes as those involving drugs, firearms, smuggling, illegal recruitment, and corruption of public officials. In white slavery cases, for example, methods of procuring women range from harmless and seemingly unrelated activities like foreign training or internship, adoption, family tours, religious pilgrimage, cultural exchange/promotion, sports events, and escort service, to cultural (marriage matchmaking or selling of a woman by her family), economic (job promises by illegal recruiters), and criminal (abduction).

Human trafficking is best understood against the background of poverty and "sexploitation." But at a higher level, the phenomenon of globalization has to be taken into account in understanding the full dimensions of the problem. More precisely, trafficking must also be analyzed in terms of the structural inequality between developing nations and the industrialized countries which have made use of their weaker counterparts as sources of labor and sex commodities. The more affluent are placed in a position where they can demand women and children as part of their consumable imports from countries that are poorer.[41] What then commences as an internal problem escalates to full-blown globalization with the poorer countries providing the merchandise and the industrialized nations acting as zealous consumers. This exploitation of women and children has been facilitated by modern information networks, the latest of which is the use of cyber communications to advertise and prostitute them.[42]

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40. *Slavery, Servitude, Forced Labour and Similar Institutions and Practices Convention of 1926*, March 9, 1927, 60 L.N.T.S. 253, http://www1.umn.edu/humanrts/instree/f1sc.htm [hereinafter Slavery Convention of 1926]; UDHR, G.A. Res. 217A(III); ICCPR, G.A. Res. 2200A (XXI); ICESCR, G.A. Res. 2200A (XXI); Convention for the Suppression of the Traffic in Persons and of the Exploitation of the Prostitution of Others, July 25, 1951, 96 U.N.T.S. 271; *Convention on the Elimination of All Forms of Discrimination against Women*, G.A. Res. 34/180, U.N. GAOR Supp. No. 46 at 193, U.N. Doc. A/34/46 (1981); *Convention on the Rights of the Child*, G.A. Res. 44/25, UN GAOR, 54th Sess., Supp. No. 49 at 7, U.N. Doc. A/54/49 (2000).

41. COALITION AGAINST TRAFFICKING IN WOMEN – ASIA PACIFIC, TRAFFICKING IN WOMEN AND PROSTITUTION IN THE ASIA PACIFIC (1996).

42. Flerida Ruth P. Romero, Judicial Use of International Conventions in Asia, in General, and in the Philippines, in Particular, to Foster Children's Rights: Sex Trafficking,

What is alarming and causing countries to focus their sights on this global concern is its growing incidence. So rampant is the practice that Secretary Colin Powell remarked: "It is incomprehensible that trafficking in human beings is taking place in the 21st Century – incomprehensible but true. Trafficking leaves no land untouched, including our own."[43]

Here in the United States, you have the Trafficking Victims Protection Act of 2000[44] and the Trafficking Victims Protection Reauthorization Act of 2003[45], both of which provide the necessary tools to fight human trafficking within and beyond United States soil. From figures released by the State Department, around 800,000 to 900,000 people are trafficked worldwide, including 18,000 to 20,000 in the United States alone. Most of these "human commodities" are women and children who are forced, intimidated or tricked into sexual or labor exploitation. Unfortunately, in the Philippines, there is a dearth of baseline data on the true state of human trafficking, due to among other reasons:

> [T]he underground nature of trafficking; the stigma placed on victims of sexual exploitation; the lack of a name for the problem in the community level and awareness of acts of trafficking as violations of human rights, thus, the low rate of reporting; and the same lack of awareness among many government agencies and non-governmental organizations, thus, the few interventions and documentation of cases.[46]

It is widely known, however, that the countries where Filipino women and children are abused and prostituted include Hong Kong, Malaysia, Japan, Korea, Nigeria, Cyprus, Greece, Germany, Italy, the United States, and the Commonwealth of the Northern Marianas Islands.

On cross-border trafficking, Japan is said to have the largest sex market for Asian women with over 150,000 non-Japanese women involved, mainly from the Philippines and Thailand. It is estimated that foreign women's earnings in the sex industry account for one to three percent of Japan's GNP, which equals the military budget. In Korea, the economic crisis in 1997 led to further feminization of migrant labor, and there has been an increase in the number of women who have entered the sex industry. The market for women targeted for "sexploitation" has immensely expanded due to websites and the Internet.

Address at the 4th Biennial International Conference of the International Association of Women Judges (1998).

43. BUREAU OF PUBLIC AFFAIRS, THIRD ANNUAL TRAFFICKING IN PERSONS REPORT (June 10, 2003).

44. Trafficking Victims Protection Act of 2003, 22 U.S.C. § 7101 (2003).

45. Trafficking Victims Reauthorization Act of 2003, Pub, L. No. 108-193 (2003).

46. Jean Enriquez, Jean, *"Trafficking of Women and Children: Updates, Trends and Challenges"*, FOCUS (ASIA-PACIFIC HUMAN RIGHTS INFORMATION CENTER), Sept. 2004, at 2, http://www.hurights.or.jp/asia-pacific/no_37/focus37.pdf. CATW-ASIA PACIFIC, April 2003.

Those countries that are signatories to United Nations documents dealing with the fundamental rights of women and children are committed to enacting national legislation to implement the policies embodied therein. Let me cite the Philippines as an example. It took eight years of lobbying and intensive spadework on the proposed anti-trafficking bill for a non-governmental organization, the Coalition Against Trafficking in Women, to finally convince Congress to enact on May 26, 2003, Republic Act No. 9208 entitled "An Act To Institute Policies To Eliminate Trafficking In Persons Especially Women And Children, Establishing The Necessary Institutional Mechanisms For The Protection And Support Of Trafficked Persons, Providing Penalties For Its Violations, And For Other Purposes."[47] Profiting from several attempts of the international human rights community to define and criminalize the act, it was able to formulate a comprehensive definition in its Section 3(a) of "trafficking in persons" which included the elements of transporting of persons, with or without the victim's consent or knowledge, within or across national borders, by means of force or other forms of coercion, or the giving or receiving of payments or benefits, for the purpose of sexual exploitation, forced labor or services, slavery, servitude or the removal or sale of organs.

In the case of nations, like the United States, which are not signatories to these international instruments, the provisions are not binding. What could only motivate them to take measures to fight human trafficking, for instance, are their own internal commitment to human rights and pressures from the international community which, more often than not, are rather weak. Certain scholars have attributed the lack of prosecution of traffickers in the U.S. to institutional attitudes such as the prevailing idea that human rights violations occur only in other countries, and there is a perceived reluctance to accept scrutiny on issues which it considers to be within its domestic purview.

Despite world-wide acknowledgment that such a transnational problem as human trafficking requires transnational solutions and global cooperation, it is still the stark reality that an estimated four million human beings, women and men, are trafficked each year, earning profits for the criminal networks of up to $7 billion annually. Evidently, it is not for lack of treaty law, customary international law or "soft law" that the problem still straddles the globe. "Soft law" here refers to sets of standards, principles or guidelines, and codes of conduct which may be useful for governments to incorporate into their national law, coupled with a plan or agenda of action.

For one thing, trafficking, while rooted in poverty, implicates not merely economic considerations but civil, political, social, and cultural rights as well. To illustrate, such stereotypes in our cultures have to be abolished that regard women and girls as little more than commodities to be marketed for gain, especially since the social and cultural patterns perpetuate the inferior status of women to men.

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47. Anti-Trafficking in Person's Act of 2003, Republic Act No. 9208 (2003) (Phil.), *at* http://www.chanrobles.com/republicactno9208.html.

Then countries that are parties signatory to the relevant United Nations instruments dealing with fundamental rights of women and children have to ensure that the pertinent legislation is in place; that there is sufficient political will on the part of their leaders, especially the Executive, to implement and enforce its provisions and finally that the Judiciary takes every opportunity to interpret the substantive provisions in accordance with the legislative intent. With your indulgence, let me inject a personal note in connection with the important role that judges can play in combating trafficking, especially of women and children, and other illegal activities relating thereto. During the six years of my nine-year term that I sat as the only female Justice in the Supreme Court of the Philippines, I never let pass any opportunity to uphold the self-esteem of women who suffer indignities and abuse in the hands of their husbands or powerful male figures in the workplace or the community. Male colleagues or associates do need reminding as they still entertain stereotyped notions regarding women. Whatever I imbibed in international Conventions on the status of women, starting with the International Women's Year Conference in Mexico in 1975, found their imprint in decisions I crafted over the years.

To heighten this awareness on the part of lower court judges, several groups of women lawyers, with the blessings of the Chief Justice of the Supreme Court, conducted a competition among these judges for the purpose of giving what they called "Gender Justice Awards" to those who have demonstrated in their decisions an understanding of the plight of women who have suffered injustice in the cases pending in their courts whether these women were plaintiff or defendant.

Another obstacle that stands in the way of effecting a successful campaign against trafficking is that some administrative officers view the problem as one related to immigration. They betray their biases and prejudices when they see that most of the people victimized come from marginalized sectors. Still others harbor the false notion that those forced into prostitution and forced labor have brought these upon themselves and have nobody else to blame. While the victim may indeed be the visible factor in the equation, there are several actors at the transnational level who contribute and aggravate the problem such as the recruiter, pimp, airport officials, immigration officials, establishment owners in destination countries, buyers, governments that consider overseas migration as the primary employment strategy and governments that earn from the sex industry.[48]

On the other hand, enforcement mechanisms are either inadequate or ineffective due to apathy, lack of political will, and adverse but powerful economic and social forces. Both treaty law and the United Nations Charter-based human rights provisions have opened the door for advocates to press for the implementation of the enforcement remedies but NGOs have not found much use for these.

48. *See* Enriquez, *supra* note 46.

XII. INTER-COUNTRY ADOPTION

A deplorable aspect of trafficking in human beings engaged in by TOCGs is that of transporting babies across borders for profit in the guise of adoption.

Originally resorted to by childless couples within the confines of their respective countries, adoption has metamorphosed into a lucrative business with global dimensions with the subject being treated as an object governed by, just like any other commodity, the law of supply and demand. Just to show the resulting interplay of laws of different jurisdictions in the process of adoption, a baby born in the Philippines may be adopted in Indonesia by American parents living in the United States who may bring the child home through Malaysia.

International adoptions used to occur in the wake of wars and humanitarian crises. For instance, American couples after World War II adopted European orphans mainly from Germany, Italy, and Greece; then after the Korean War, from Korea and after the Vietnam conflict in 1975, some 3,000 children were given to foreign parents as part of Operation Babylift.

Between 1988 and 2001, statistics show a doubling of inter-country adoptions from 19,000 to over 34,000. The United States which has always adopted the greatest number of foreign children looks to China and Russia as its major suppliers. In 2001, Americans accounted for 19,237 international adoptions which is more than half of the world's total.[49]

As the demand outstrips supply due to changing norms in traditional societies, various social and economic pressures, as well as the HIV/AIDS pandemic which is leaving large numbers of children orphans, the TOCGs are experiencing a boom in illegal adoptions, with an infant costing between $5,000 and $25,000 or being exchanged for appliances or commodities considered as luxury items by biological parents in poor countries. Consequently, the temptation is great for unscrupulous dealers to abduct or kidnap babies for sale to adoptive families or enter into under-the-table arrangements with orphanages to supply them with these children on a regular basis, more often than not, falsifying documents in the process.

While recognizing that legitimate adoption fills the need for creating loving relationships between families eager to have a child or have more and babies bereft of caring parents, the international community cannot close its eyes to the corrupt practices being spawned by this trade of marketing infants across continents. But one is hard put to say when legitimate adoption shades off into illegal trafficking. Moratoria have been known to have been imposed on certain supplier countries to curb corruption, but these have been futile. Clearly, measures designed to regulate global adoption were called for in the mid-1900s.

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49. Ethan B. Kapstein, *The Baby Trade*, *in* FOREIGN AFFAIRS (2003).

A major development which augured well for international adoption was the adoption of the Convention on the Rights of the Child (CRC)[50] in 1989 as an offshoot of multilateral discussions in the United Nations to establish guidelines and norms in this field. The 191 states that are party to the CRC are directed to conclude "multilateral arrangements or agreements" to establish a transparent process for adopting children across national borders, including the enactment of necessary national legislation.

In 1993, a little-known inter-governmental organization established 100 years earlier called the Hague Conference on Private International Law responded by drafting a Convention on international adoption which was unanimously endorsed by its member countries. The resulting Hague Convention on Protection of Children and Cooperation in Respect of Intercountry Adoption,[51] signed by fifty-four countries, seeks "to take measures to ensure that intercountry adoptions are made in the best interests of the child and with respect for his or her fundamental rights, and to prevent the abduction, the sale of, or traffic in children."[52]

Recognizing that child trafficking, like terrorism and the drug trade, can only be curbed through multilateral cooperation, the Hague Convention requires each state to designate a "central authority" to oversee the adoption process in its own territory, including the implementation of its directives through new domestic legislation and the coordination of adoption procedures with other states. The supplying countries are directed to clean up corrupt adoption networks and receiving countries and to crack down on the receipt of trafficked children.

Heeding the call of the Hague Convention, the Philippines passed Republic Act No. 8043, known as the "Inter-Country Adoption Act of 1995"[53] allowing for the first time the adoption of Filipino children by aliens or Filipino citizens permanently residing abroad where this will prove beneficial to the child's best interests, provided that the maximum number allowed for foreign adoptions shall not exceed six hundred a year for the first five years. It created the Inter-Country Adoption Board as the central authority in matters relating to inter-country adoption.

On the other hand, the U.S. Congress passed its Intercountry Adoption Act[54] in 2000 with the State Department as its designated central authority. Much-needed regulations have yet to be established especially since adoption

50. Convention of the Rights of the Child, Nov. 20, 1989, http://www.unhchr.ch/html/menu3/b/k2crc.htm.

51. Hague Convention on Protection of Children and Cooperation in Respect of Intercountry Adoption, May 29, 1993, http://www.legallanguage.com/Hague/haguetx33e.html.

52. *Id.*

53. Inter-country Adoption Act, Republic No. 8043 (2005) (Phil.), *at* http://www.chanrobles.com/republicactno8043.htm.

54. Intercountry Adoption Act, 42 U.S.C. § 14901 et seq. (2005).

falls under the jurisdiction of the individual states and not the national government. Other countries are expected to follow suit if only to restore the legitimacy of the adoption process and the dignity of innocent babies.

The foregoing discussions on the involvement of TOCGs in such nefarious activities as terrorism, trafficking in human beings, and intercountry adoptions are but the tip of the iceberg demonstrating the downside of globalization. Studies and their accompanying statistics do show that despite measures at the international, regional, and national level to stamp out these heinous activities of TOCGs, the profit factor, the apathy of national officials, ineffective enforcement mechanisms and formidable economic and social pressures are too overwhelming to bring about a solution to the problem. Indeed, the race against the evolving face of crime, including this relatively new genre of TOC, seems to be almost hopeless for crime, as in other parts of the world, is always one or two steps ahead.

Another major obstacle to punishing TOC is judicial restraint. For TOCGs, the physical boundaries of nations do not exist. In dealing with TOCGs, there is bound to be a conflict between national or municipal laws and international laws governing controversies between or among states.

The other factor to be considered is the effectiveness of international conventions vis-à-vis domestic laws. To quote some scholars, "In view of the jurisdictional and political weaknesses of international tribunals, are national courts the more promising avenue in certain fields for the growth of a body of law regulating state conduct?" They sought to provide some enlightenment by saying that the two principles of judicial restraint must first be considered. Thus, they said that even if the doctrine of sovereign immunity and the act of state doctrine are similar in that they prevent

> courts from becoming involved in disputes which might lead to friction between a foreign nation and their own ... sovereign immunity applies only where a foreign state or its instrumentality is sought to be made a *party* to litigation or where its property is involved. On the other hand, the act of state doctrine focuses entirely on the *action* taken by that state, and may be applicable to litigation between two private parties to which that action is relevant. It determines not whether a court can assert (or must relinquish) *jurisdiction* over a party but whether it can fully examine and decide certain claims *on the merits*, even when such claims rest on the asserted illegality of foreign governmental conduct.[55]

Without clear rules on conflicts of laws, problems may arise in executing judgments of conviction against foreign nationals.

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55. HENRY J. STEINER ET AL., TRANSNATIONAL LEGAL PROBLEMS (1994).

We see no quick solution to the problems posted by TOC in our jurisdiction. Our Supreme Court, however, has of late dealt on some matters which, under existing Philippine law and jurisprudence, are quite innovative although already accepted in other jurisdictions.

For instance, the results of DNA[56] testing were previously considered insufficient as an evidentiary tool. Dean Pacifico Agabin of the University of the Philippines College of Law, in one of his lectures, stated: "The novelty of the scientific method for DNA testing should not be a ground for exclusion of evidence under (Philippine) rules. Neither should degradation of the specimen be invoked against admission, since this goes merely into the weight, rather than admissibility, of the evidence."

In the landmark case of *People v. Vallejo*,[57] the Supreme Court finally upheld the admissibility of DNA evidence in affirming the death sentence of an accused rapist-murderer. It held in part, citing the works of DNA experts:

> In assessing the probative value of DNA evidence, therefore, courts should consider, among others things, the following data: how the samples were collected, how they were handled, the possibility of contamination of the samples, the procedure followed in analyzing the samples, whether the proper standards and procedures were followed in conducting the tests, and the qualification of the analyst who conducted the tests.[58]

I am happy to say that the Philippine Judiciary has been quite proactive in adopting measures that are already being utilized in other progressive jurisdictions in the sphere of criminal prosecution and punishment. Then again, this seems to be more of a domestic affair. What about Filipino fugitives hiding in other countries or fugitives from other countries who seek refuge in the Philippines?

XIII. EXTRADITION

In cases where extradition is proper, calling for mutual legal assistance in connection with a criminal investigation or execution of a prison sentence, extradition treaties may be resorted to, in accordance with Presidential Decree No. 1069, or the Philippine Extradition Law.[59] In this regard, the Supreme

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56. Deoxyribonucleic acid.

57. G.R. No. 144656 (2002) (Phil.).

58. WILLIAM C. THOMPSON, GUIDE TO FORENSIC DNA EVIDENCE, IN EXPERT EVIDENCE: A PRACTITIONER'S GUIDE TO LAW SCIENCE AND THE FJC MANUAL (1997); CHARLES R. SWANSON, CRIMINAL INVESTIGATION (1996); KEITH INMAN & NORAH RUDIN, AN INTRODUCTION TO FORENSIC DNA ANALYSIS (1997).

59. Presidential Decree No. 1069, Philippine Extradition Law (1977), *available at* http://www.chanrobles.com/presidentialdecreeno1069.htm.

Court has come up with a number of decisions that I would like to mention here.In *Rodriguez v. COMELEC*,[60] the Court laid to rest the nagging issue as to what the term "fugitive from justice" means. At the time, the issue was raised not for the purpose of extraditing one of the parties, Eduardo T. Rodriguez, but to disqualify him from public office. The Court allowed Rodriguez's candidacy and, eventually, his proclamation as duly elected Governor of Quezon Province by stating that:

> [T]he term *"fugitive from justice"* as a ground for the disqualification or ineligibility of a person seeking to run for any elective local position under Section 40(e) of the Local Government Code, ... includes not only those who flee *after conviction to avoid punishment* but likewise those who, *after being charged, flee to avoid prosecution.*
>
> *Intent to evade* on the part of a candidate must therefore be established by proof that there has already been a conviction or at least, a charge has already been filed, at the time of flight. Not being a *"fugitive from justice"* under this definition, Rodriguez cannot be denied the Quezon Province gubernatorial post.

It was, however, an empty victory for Rodriguez, who fled the United States in 1985 and returned to the Philippines to escape multiple charges of insurance fraud for allegedly faking the deaths of his mother-in-law and wife to illegally collect more than $150,000 in insurance policies. It turned out that his wife, Imelda, and her mother were both alive at the time of the filing of the insurance claims. On November 25, 2003, he was found guilty by a jury for one count of grand theft and four counts of insurance fraud before the Los Angeles Superior Court in California and faces a possible maximum state prison sentence of eight years and $100,000 in restitution. Rodriguez was brought back to the United States by U.S. Deputy Marshals after he surrendered to a team of the Interpol Division of the National Bureau of Investigation last May 27th under threat of extradition. His wife is charged with one count of insurance fraud and is currently facing extradition charges before a Manila regional trial court.

On the other hand, in the earlier case of *Wright v. Court of Appeals*[61], the Treaty of Extradition between the Philippines and Australia was utilized when the Australian government sought the extradition of one of its citizens, Paul Joseph Wright, for offenses committed in Australia. The trial court, Court of Appeals, and the Supreme Court were unanimous in deciding that Wright's case properly fell within the purview of the treaty, *which did not specify when*

60. G.R. No. 120099 (1996) (Phil.).
61. G.R. No. 113213 (1994) (Phil.).

the crime should be or should have been committed. The Court explained the concept of extradition very clearly:

> A paramount principle of the law of extradition provides that a State may not surrender any individual for any offense not included in a treaty of extradition. This principle arises from the reality of extradition as a derogation of sovereignty. Extradition is an intrusion into the territorial integrity of the host State and a delimitation of the sovereign power of the State within its own territory. The act of extraditing amounts to a "delivery by the State of a person accused or convicted of a crime, to another State within whose territorial jurisdiction, actual or constructive, it was committed and which asks for his surrender with a view to execute justice.[62]

Not only may an individual not be surrendered unless the offense is included in a treaty of extradition, but, at least in the Philippines-U.S. Extradition Treaty, the act for which extradition is sought should be considered a crime in both the requesting state and the requested state. This "double criminality clause" thwarted the attempt of the United States to bring within its jurisdiction a young student in a computer school who, in 2000, was responsible for infecting computer systems all over the world with the "I Love You" internet virus. At the time he committed the hi-tech misdeed, it was not yet a punishable act under Philippine law. Consequently, he was neither prosecuted in Philippine courts nor extradited to the United States.

In *Cuevas v. Muñoz*, the extradition of the respondent was being sought by Hong Kong's Magistrate Court for crimes allegedly committed in Hong Kong.[63] The respondent claimed that his right to due process was violated when the trial court admitted the request for his provisional arrest and its supporting documents despite lack of authentication. Relying on its earlier pronouncement in *Secretary of Justice v. Hon. Lantion*,[64] the Court stated:

> In tilting the balance in favor of the interests of the State, the Court stresses that it is not ruling that the private respondent has no right to due process at all throughout the length and breath of the extrajudicial proceedings. Procedural due process requires that a prior determination . . . should be made as to whether procedural protections are at all due and when they are due, which in turn depends on the extent to which an individual will be condemned to suffer grievous loss. . . In sum, we rule that the temporary hold on private respondent's

62. *Id.*
63. G.R. No. 140520 (2000) (Phil.).
64. G.R. No. 139465 (2000) (Phil.).

> privilege of notice and hearing is a soft restraint on his right to due process which will not deprive him of fundamental fairness should he decide to resist the request for his extradition to the United States. There is no denial of due process as long as fundamental fairness is assured a party.[65]

This case was further refined in *U.S. v. Purganan*[66] where one of our Congressmen from Manila challenged extradition proceedings initiated by the Department of Justice on behalf of the United States Government. Congressman Mark B. Jimenez was the subject of an arrest warrant issued by the United States District Court for the Southern District of Florida on five indictments. In granting the petition, thereby paving the way for the respondent's extradition, the Supreme Court further explained the nature of extradition proceedings thus:

> By nature then, extradition proceedings are not equivalent to a criminal case in which guilt or innocence is determined. Consequently, an extradition case is not one in which the constitutional rights of the accused are necessarily available. It is more akin, if at all, to a court's request to police authorities for the arrest of the accused who is at large or has escaped detention or jumped bail. Having once escaped the jurisdiction of the requesting state, the reasonable prima facie presumption is that the person would escape again if given the opportunity.
>
> On the other hand, courts merely perform oversight functions and exercise review authority to prevent or excise grave abuse and tyranny. They should not allow contortions, delays and 'over-due process' every little step of the way, lest these summary extradition proceedings become not only inutile but also sources of international embarrassment due to our inability to comply in good faith with a treaty partner's simple request to return a fugitive. Worse, our country should not be converted into a dubious haven where fugitives and escapees can unreasonably delay, mummify, mock, frustrate, checkmate and defeat the quest for bilateral justice and international cooperation.[67]

Jimenez is currently serving a twenty-one-month prison sentence after pleading guilty to two counts of tax evasion and one count of conspiracy to defraud the United States and commit election financing offenses.

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65. *Id.*
66. G.R. No. 148571 (2002) (Phil.).
67. *Id.*

I daresay that these pronouncements on extradition will assume growing importance as TOCGs continue to unleash attacks ignoring inter-country boundaries and heedless of international sanctions.

XIV. CONCLUSION

A quantum leap into cyberspace has indeed transformed our vast world into a "global village." For good or ill, it has breached natural and artificial barriers among nations, thus facilitating the exchange of commodities, services, information and technology, and the adoption of social and cultural patterns. For lack of a "filtering device" and an effective mechanism, it has not been possible to treat countries even-handedly resulting in preferential treatment of some at the expense of others or in the dissemination of undesirable, even dangerous information.

For mutual protection and closer coordination, countries are constrained to set up tighter networking systems and enter into multilateral agreements culminating in treaties, conventions, resolutions, and various kinds of *modus vivendi*.

All too soon, mankind has realized that it has to accept the evils of globalization along with its blessings. To ask whether it is a boon or a bane is posing a rhetorical question. What is certain is that this relatively recent phenomenon is raising legal challenges never anticipated in the past. Leaders and the governed alike are forced to draw upon their reserves of creativity, imagination, foresight, and intuition to cope with, and possibly rein in, a juggernaut in the making.

Indeed, a multitude of legal problems and issues have sprung, which continue to call for innovative legal solutions that could keep apace with the dizzying rate of change. It behooves all of us, therefore, particularly lawyers and judges, to be mindful of the role each one can play in the ever-expanding world of the law for it is the rule of law that makes the attainment of lasting peace and harmony possible. It is the rule of law that enables us to preserve time-honored institutions which are the hallmarks of civilized society. It is the rule of law that empowers us to do what we have to do now so that our children can survive in an increasingly competitive world.

SCOTLAND'S BASTARD VERDICT: INTERMEDIACY AND THE UNIQUE THREE-VERDICT SYSTEM

Joseph M. Barbato*

Veredictum quasi dictum veritatis; ut judicium quasi juris dictum.†

I. INTRODUCTION

In 1707, the separate kingdoms of Scotland and England reached an accord whereby each was dissolved and the two united into the new Kingdom of Great Britain.[1] After three hundred years, the Scottish Parliament has devolved from the larger Parliament of the United Kingdom.[2] Scotland's desire to retain sovereignty is apparent in retrospect. For instance, one of the important Acts of Union between both countries' parliaments in the early 1700s was to preserve the separate identity of the Scottish legal system and institutions.[3]

This note will consider one small but emblematic part of Scotland's legal system, the verdict of "not proven." Part Two begins with the concept of Scotland's national identity, and follows the chronological development of the country's three-verdict system. With this foundation, two comprehensive legal reviews involving the not proven verdict, both of which resulted in its retention, are discussed. Part Three examines post-millennial developments in the not proven debate, and also compares how this uniquely Scottish verdict has made an imprint on the American legal system. Finally, Part Four takes into account renewed controversy in Scotland over the verdict, recognizing that the potential costs of doing away with "not proven" currently outweigh possible benefits.

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* J.D. candidate, May 2005. M.F.A., Purdue University, 2002. B.A., Purdue University, 1998. The author would like to thank his wife, Hannah, for her love, support, and forbearance throughout the law school experience. He also wishes to thank Dr. Christine Slater for taking time to locate several sources in Scottish libraries, and the Executive Board of Volume 14 for seeing enough potential to select this note for publication.

† "A verdict is, as it were, the saying of the truth, in the same manner that a judgment is the saying of the law (or right)." BLACK'S LAW DICTIONARY 1699 (7th ed. 1999).

1. Michael C. Meston, *Scots Law Today*, *in* THE SCOTTISH LEGAL TRADITION 1, 2 (new enlarged ed., Scott C. Styles ed., 1991).

2. *See* Scotland Act, 1998, c. 46 (Scot.), http://www.hmso.gov.uk/acts/acts1998/19980046.htm (last visited Feb. 19, 2005).

3. Meston, *supra* note 1. While this was true, Meston points out that "[t]here was little protection for the substance of the existing Scots law." *Id.* Perhaps this gave increased importance to maintaining the institutions applying the law, such as the Court of Session (civil court) and Court of Justiciary (criminal court), which "were to remain in all time coming within Scotland." *Id.*

II. SOMEWHERE IN THE MIDDLE

Today, the status of Scotland within the international community is not easily categorized. Standing alone, Scotland is neither solely whole nor part, but somewhere in the middle. Perhaps it is both. For example, a Scotsman would never agree that he was also an Englishman, but would concede that both are nonetheless Britons.[4] This same attitude is found in the legal profession, where the "fierce independence of the Scots lawyer" is directly connected to the fear "that a merger with English law would, through English ignorance, become a mere abolition of Scottish law and institutions."[5]

Lord Cooper[6] suggests that Scottish law and society are inextricably linked: "[O]f all the items which add up to make the sum total of [Scotland's] heritage none is more distinctive than Scotland's contribution to law."[7] By preserving the identity of its legal institutions, Scotland has also preserved its societal heritage, because "Scots Law is in a special sense the mirror of Scotland's history and traditions and a typical product of the national character, and it is just as truly a part of [the] national inheritance as [the] language or literature or religion."[8]

This attribute of being in the middle—intermediacy, for lack of a better term—is also an intrinsic characteristic of the Scottish legal system, which holds an "ambivalent position" between the common law (of English or Anglo-American heritage) and the civilian tradition (also called Continental or Romano-Germanic).[9] As Lord Cooper says, "Scotland stands apart, content with a system of her own devising, which . . . now occupies a position somewhere midway between the two great opposing schools."[10] Furthermore, "Scots law is unique in the extent to which it has drawn on and been influenced by both these great traditions throughout most of its long history."[11] This

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4. *Id.* at 1. Meston also points out the surprise of foreigners at the degree of separation of the countries' parts, apparent in the confusion in naming the country as England, Great Britain, or the United Kingdom of Great Britain and Northern Ireland. *Id.*

5. *Id.* at 3.

6. Former President of the Court of Session, and author of the original text entitled *The Scottish Legal Tradition*. Scott C. Styles, *Introduction* to THE SCOTTISH LEGAL TRADITION xi (new enlarged ed., Scott C. Styles ed., 1991).

7. Lord Thomas Mackay Cooper, *The Scottish Legal Tradition*, *in* THE SCOTTISH LEGAL TRADITION 65 (new enlarged ed., Scott C. Styles ed., 1991).

8. *Id.*

9. W. David H. Sellar, *A Historical Perspective*, *in* THE SCOTTISH LEGAL TRADITION 29 (new enlarged ed., Scott C. Styles ed., 1991); *see also* Alexander J. Black, *Separated by a Common Law: American and Scottish Legal Education*, 4 IND. INT'L & COMP. L. REV. 15, 17-20 (1993) (discussing the historical background of Scottish legal philosophy, and stating that "Scotland [has] a mixed legal system, part civil law, part common law, as is the nominal classification in Québec, Louisiana, or South Africa").

10. Cooper, *supra* note 7, at 66.

11. Sellar, *supra* note 9, at 29-30. Sellar also says that "Scots law has always been more of a hybrid than Cooper was prepared to admit, and the influence of the Civil or Roman law on

history is "one of great antiquity and continuity," itself a distinguishing feature of Scottish law, "which can be traced from the earliest times of which there is any record right down to the present day."[12]

In this context, Scottish intermediacy is echoed in its three-verdict criminal system, in which a Scottish jury[13] returns a verdict by majority, and "may, unless they have been specially directed in law that one or another is not open to them, be any one of 'guilty,' 'not guilty,' or 'not proven.'"[14] While the first two are self-explanatory, the third, being found somewhere in the middle, requires clarification.[15] Unfortunately, there is no common law or statutory definition of "not proven."[16] Even so, one of its defining features is that it counts as a vote for acquittal, resulting in the verdicts of not guilty and not proven having exactly the same legal effect.[17] A verdict of not proven, however, carries more than mere legal effect: "It is generally suggested that a verdict of not guilty means that the judge or jury thinks that the accused definitely did not commit the crime . . . , whereas a verdict of not proven means merely that the judge or jury has reasonable doubt as to the accused's guilt."[18] The implication that the accused's guilt has not been conclusively demonstrated[19] has resulted in the labeling of the not proven verdict as a "'second class' acquittal."[20]

Perhaps because of these implications, the not proven verdict "continues to attract bemused attention from outside Scotland."[21] At the same time, it is a source of frustration within Scottish jurisprudence, especially for those people

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Scots law has never operated in a context unaffected by the countervailing influence of the English Common law." *Id.* at 30.

12. *Id.* at 29. Sellar puts forth that "[i]n England and Scotland, . . . apart from the brief period of Commonwealth and Protectorate in the mid-17th century, there has been no revolution, nor has a written code of law been adopted to mark a new departure." *Id.*

13. "[I]t is important to note that the verdict of not proven is available also to sheriffs hearing summary cases and to justices in the district court," both without juries, who return the verdict in around one-fifth of their acquittals, as compared to about one-third by juries. Peter Duff, *The Not Proven Verdict: Jury Mythology and "Moral Panics"*, 41 JURID. REV. 1, 7 (1996).

14. DAVID M. WALKER, THE SCOTTISH LEGAL SYSTEM 550 (8th ed. rev., W. Green/Sweet & Maxwell, Edinburgh 2001). "Importance attaches to corroboration; by Scots law every essential fact must be corroborated, *i.e.*, the evidence must be supported by independent evidence from another witness or from facts and circumstances justifying an inference to the same effect." *Id.* at 549. The jury may give its verdict unanimously, or by a majority. *Id.* at 529.

15. Duff, *supra* note 13, at 6; *see also* W. M. GLOAG & R. C. HENDERSON, INTRODUCTION TO THE LAW OF SCOTLAND 764 (7th ed., Alastair M. Johnson & J. A. D. Hope eds.,W. Green & Son Ltd., Edinburgh 1969).

16. Peter Duff, *The Scottish Criminal Jury: A Very Peculiar Institution*, 62 LAW & CONTEMP. PROBS. 173, 193 (1999).

17. Duff, *supra* note 13, at 6.

18. *Id.*

19. Duff, *supra* note 16.

20. Duff, *supra* note 13, at 6 (quoting the 1975 Thomson Committee report on criminal procedure in Scotland).

21. Meston, *supra* note 1, at 27.

annoyed with the "ambivalent position" of an intermediate verdict, who prefer a bright line rule or black-letter law.[22] One such person was Sir Walter Scott.[23] In 1827, after attending the trial of a woman accused of poisoning a servant girl, he wrote in his diary: "She is clearly guilty, but as one or two witnesses said the poor wench hinted an intention to poison herself, the jury gave that bastard verdict, not proven."[24] He went on, "I hate that Caledonian *medium quid*. One who is not proved guilty is innocent in the eyes of the law."[25]

Scott was neither the first nor last to speak out on the verdict, as shown by Willock's preface to a discussion of the topic: "The history of the three modern Scottish verdicts holds a particular interest in view of the frequent controversies that have arisen as to the desirability of the apparently anomalous verdict of 'not proven'."[26] Lord Cooper shares this general sentiment, suggesting, "If you would know what a thing is, you must know how it came to be what it is: and if we are to acquire a just perspective for a brief survey of the modern law, we must consider first the pedigree of its leading doctrines."[27]

A. Chronological History of the Caledonian Medium Quid

For approximately 300 years, the not proven verdict has been a part of the Scottish criminal justice system, even though it is the "product of historical accident."[28] More specifically, the verdict's origin has been to some extent "traced to the recognition of the inability of an unskilled jury to interpret the significance of particular facts."[29] As a result, "if it is to be regarded as an institution to be valued, it can scarcely be claimed as a manifestation of the

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22. Sellar, *supra* note 9.

23. Neil Gow, *The Case for Not Proven,* 143 NEW L. J. 753 (1993). Scott was not only a novelist, but also an advocate and sheriff in Selkirk. *Id.*

24. *Id. See also* IAN DOUGLAS WILLOCK, THE ORIGINS AND DEVELOPMENT OF THE JURY IN SCOTLAND 217 n.1 (The Stair Society, Edinburgh 1966). Scott also told her advocate: "All I can say is, that if that woman was my wife, I should take good care to be my own cook." Allan Massie, *Arguing the Case for Our 'Bastard Verdict'*, SCOTSMAN, Nov. 22, 2004, at 17.

25. WILLOCK, *supra* note 24, at 217. Willock records the last line as "not proved" while Gow quotes it as "not proven." Gow, *supra* note 23. In a 1995 debate on the verdict, after Sir Walter Scott's famous line was quoted, one Member of Parliament stated:

> [I]t is worth pointing out . . . that one of the reasons that Sir Walter Scott was driven to write the Waverley novels was the fact that, up to then, he had had a rather unsuccessful career at the Scottish Bar. While he may be regarded as an authority on the 19th-century novel, he is not generally regarded as someone upon whom great reliance can be placed in important matters of Scots law.

221 PARL. DEB., H.C. (Hansard) (June 7, 1995) [hereinafter Hansard].

26. WILLOCK, *supra* note 24, at 217.

27. Cooper, *supra* note 7, at 67.

28. Duff, *supra* note 13, at 6. "The not proven verdict does not appear to be, or to have been, used in any other legal system." SCOTTISH OFFICE, JURIES AND VERDICTS: IMPROVING THE DELIVERY OF JUSTICE IN SCOTLAND 26 (HMSO, Edinburgh Press 1994) [hereinafter JURIES AND VERDICTS].

29. J. Irvine Smith, *Criminal Procedure, in* INTRODUCTION TO SCOTTISH LEGAL HISTORY 426, 442. (Robert Cunningham & Sons, Ltd., Alva, Scotland 1958).

genius of Scottish criminal jurisprudence."[30]

1. Sixteenth Century and Earlier

The early juridical practice was to frame indictments in general terms, leaving the determination of guilt or innocence to the jury.[31] Rudimentary records reveal that juries employed a wide variety of terminology to convey its verdict, following no set form.[32] For instance, innocence was expressed by "made qwyt" (made quit) or "deliuerit innocent" (delivered innocent), and sometimes by "clene and sakles" (clean and sakeless).[33] Guilt was rarely proclaimed by the simple use of "guilty," and more commonly by "convictus" or "convicit" and the phrases "in wrang" (in wrong) or "had done wrangis."[34] The Justice Court at this time used similar terms to denote culpability and acquittal, with the addition of "fylit" (fouled) for guilty and "clangit" (cleaned) for innocent.[35] Furthermore, isolated examples of "Giltye" and "nocht giltie" are found used in Edinburgh in the latter part of the sixteenth century.[36]

2. Seventeenth Century

A practice was adopted during the reign of Charles II that postponed the use of guilty and not guilty until the eighteenth century.[37] Instead, the custom of producing indictments, including a long list of charges, emerged.[38] Following from this, special verdicts for each charge, "proven" or "not proven," were introduced.[39] "The practice which thus arose of the jury finding certain facts proved was encouraged when juries between 1660 and 1688 refused to convict on prosecutions brought under unpopular and repressive Statutes."[40]

The response to this refusal to convict was the introduction of a doctrine stating that "in no case . . . the jury had a right to exercise their judgment upon any point except the evidence relating to the different facts charged . . . ."[41] In addition, "in every case they were to decide merely upon the fact; and it was the province of the judges to determine the import of their verdict, in the scale of guilt."[42] Thus, the jury "merely found each of the charges proven or not

30. WILLOCK, *supra* note 24, at 217.
31. Smith, *supra* note 29.
32. WILLOCK, *supra* note 24, at 217.
33. *Id.*
34. *Id.*
35. *Id. See also* 5 DAVID M. WALKER, A LEGAL HISTORY OF SCOTLAND 560 (T & T Clark 1998).
36. WILLOCK, *supra* note 24, at 217-18.
37. *Id.*
38. *Id.*
39. *Id.* at 218; *see also* WALKER, *supra* note 35.
40. Smith, *supra* note 29.
41. *Id.*
42. *Id.*

proven," while the "actual inference of guilt . . . was left to be drawn by the judge."[43]

3. Eighteenth Century

In the first two decades of the eighteenth century, the verdicts of guilty and not guilty fell "completely into abeyance."[44] Instead, the practice of returning special verdicts finding certain facts proven and leaving the interpretation for the judges continued until the 1726 trial of Samuel Hale.[45] Though only a step, it prepared the Scottish criminal legal system for the leap it was to make two years later. At the 1728 trial of Carnegie of Finhaven, "the jury's right to return such a verdict was emphatically reestablished," which acted to "halt . . . a process of attrition which might have led to the total extinction of the criminal jury."[46]

But the verdict of not proven did not "fall into the limbo of legal antiquities."[47] Juries retained the use of the special verdict, putting it into practice at the trial of Captain Porteous in 1736, finding each stage in the commission of the charged offense proven.[48] In his lectures on the subject, David Hume[49] explained the "new shade of meaning" acquired by the verdict:

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43. WILLOCK, *supra* note 24, at 219. This change is attributed to the 1662 case of Marion Lawson, who was accused of murdering her newborn child. *Id.* The jury became confused as to the presumptions arising from facts presented, and was unwilling to convict on the evidence. *Id.* Perhaps this was because the jury received no direction from the bench. Smith, *supra* note 29.

44. WILLOCK, *supra* note 24, at 220.

45. Smith, *supra* note 29. Hale was accused of homicide. WILLOCK, *supra* note 24, at 220. The jury was satisfied with his defense, and without question from the bench brought a general verdict of not guilty. *Id.*

46. WILLOCK, *supra* note 24, at 220-21. The accused was charged with the murder of the Earl of Strathmore, to which a defense of drunkenness was asserted. *Id.* While the evidence left no doubt of a fatal wounding during a quarrel, the accused claimed he had lacked the intent to cause death. *Id.* Carnegie's advocate requested a verdict of not guilty, assuring the jury that it remained a competent verdict, after which they found as he proposed. *Id.* In the crucial moment, it is recorded that Carnegie's zealous advocate

> [I]nsisted[] that this was the critical moment which was either to rivet the prerogative of the crown over the privileges of the jury, or to emancipate them from the subordination and insignificance into which they had been degraded by a government[.] And that the liberties of their country, the blood of the innocent, and their future peace of mind, depended upon the degree of justice and resolution which they should display in the verdict they were about to pronounce.

S. A. Bennett, *Not Proven: The Verdict*, 12 SCOT. L. TIMES 97, 97-98 (2002).

47. WILLOCK, *supra* note 24, at 221.

48. *Id.*

49. Most famous for his philosophical writings, Hume also studied and practiced law in Edinburgh. DAVID M. WALKER, THE SCOTTISH JURISTS 316-17 (W. Green & Son, Ltd. 1985). He was recently voted as the "Scot who had made the greatest impact on Scotland in the last 1,000 years." Famous Scots – David Hume, *at* http://www.rampantscotland.com/famous/blfamhume.htm (n.d.) (last visited Feb. 23, 2003).

"Not uncommonly, the phrase not proven has been employed to mark a deficiency only of lawful evidence to convict . . . and that of not guilty, to convey the jury's opinion of his innocence of the charge."[50]

4. Nineteenth Century

By the 1830s, special verdicts were largely obsolete.[51] However, the not proven verdict continued to be "retained for those cases in which there was insufficient lawful evidence to convict, but suspicion attached to the prisoner."[52] Furthermore, a consequence developed whereby "the verdict of not proven carrie[d] with it a certain stigma, as if the jury wished to record their disapproval of the accused and his behaviour."[53] Even so, "[w]hether the verdict of the Jury be in this form . . . , or not guilty, . . . the benefit is the same to the prisoner. He is for ever freed from any farther proceedings in regard to the matter laid before the Jury."[54]

The cases from this period are full of intrigue because of the not proven verdict's new implications, as well as a major ramification of its use: avoidance of a death sentence, which was restricted to murder, piracy, and treason by the end of the century.[55] "[J]uries frequently took refuge" in the not proven verdict to "avoid imposition of a capital sentence . . . ."[56] The 1857 trial of Madeleine Smith was one example of a jury's use of the "hybrid verdict" for this purpose.[57] There, no direction was given to the jury concerning the possible verdicts or their consequences, which seems to have been regarded by that time as common knowledge.[58]

Two other cases, both brought on charges of murder, also display the verdict in action. The 1843 trial of Christian Gilmour, involved the death of her husband after he consumed quantities of arsenic.[59] Christian's father disallowed her betrothal to a poor young farmer, and instead arranged her

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50. WILLOCK, *supra* note 24, at 221 (quoting Hume).

51. 6 DAVID M. WALKER, A LEGAL HISTORY OF SCOTLAND 456 (Butterworths/LexisNexis 2001).

52. Smith, *supra* note 29.

53. WILLOCK, *supra* note 24, at 221-22.

54. WALKER, *supra* note 51. This quote is from Sir Archibald Alison, a contemporary of Hume, whose "work has taken a place and achieved an esteem second only to Hume as an authority on the criminal law, and in every criminal case raising a significant point of principle or common law it is examined." WALKER, *supra* note 49, at 358.

55. S. Scott Robinson, *Nineteenth Century Criminal Justice*, 36 J. L. SOC'Y. SCOT. 151 (1991). Furthermore, "[u]ntil 1834 there were, in Scotland, still some fifty crimes (as opposed to 300 in England) which could be visited with the capital sentence . . . . [It] was finally abolished by the Murder (Abolition of Death Penalty) Act 1965, except for mutiny in time of war, piracy and treason." *Id.*

56. *Id.*

57. WALKER, *supra* note 51.

58. *Id.* at 456-57.

59. S. Scott Robinson, Nineteenth *Century Criminal Justice – The Trial of Christian Gilmour*, 37 J. L. SOC'Y. SCOT. 16 (1992).

marriage to a more established farmer, John Gilmour.[60] Eight weeks later her husband was dead, and evidence showed Christian had purchased, on two different occasions, the poison used to kill him.[61] The twenty-four-year-old woman claimed the poison was intended for herself and that she had no idea how her husband had ingested the substance.[62] An hour after retiring, the jury returned a verdict of not proven on the charge of murder.[63] It has been suggested that "the all-male jury, impressed by the mild and gentle appearance of the prisoner, and the awful consequences to her if they were to return a verdict of guilty of murder, had been much relieved to seize upon the old Scots verdict of not proven."[64]

The second case, heard by the High Court of Stirling in 1845, is that of Isabella Rae.[65] Rendered suicidal by a hard life of poverty, Isabella threw herself into a canal while clutching her two-year-old son to her chest.[66] Although she was pulled to safety, her son was drowned.[67] She was charged with murder, or in the alternative, the lesser offense of culpable homicide.[68] Her advocate mounted a "perilous but courageous line of defence," by suggesting there was no room for the lesser indictment: she was either guilty of murder, or not in a state of mind to be responsible for her actions.[69] He called for the verdict of not proven on both charges.[70] It took the jury only two hours to agree.[71] As with the Gilmour trial, perhaps the jury sympathized with this unfortunate woman, and having learned of the "conditions of abject poverty in which she was endeavouring to provide for three children, would have seized upon any explanation . . . which would save her from the death sentence . . . , with all its appalling consequences for her and for the two surviving children."[72]

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60. *Id.*

61. *Id.*

62. *Id.* This claim seems to be a recurring theme, as it was the impetus (although in a different case, occurring twenty-six years earlier) for Sir Walter Scott's historical epithet. *See supra* notes 23-24 and accompanying text.

63. Robinson, *supra* note 59.

64. *Id. See also* WILLOCK, *supra* note 24, at 221 n.12 (commenting on the "remarkable number of instances in which women charged with murder by poison were given this verdict" and suggesting that "juries were too easily swayed by improper sympathies").

65. S. Scott Robinson, *Nineteenth Century Criminal Justice – A Perilous Defence – The Trial of Isabella Rae*, 36 J. L. SOC'Y. SCOT. 309 (1991).

66. *Id.*

67. *Id.*

68. *Id.*

69. *Id.*

70. *Id.*

71. *Id.*

72. *Id.*

B. Modern Misconception and Misdirection

While it may be easy to ascribe motive to the decisions of nineteenth-century juries, it should be remembered that there is no duty upon the modern jury to explain its verdict.[73] There are times, however, when a "peep through the veil" is obtained.[74] One such instance happened when the foreman of a Scottish jury announced the verdict of "guilty by a majority," and the defense counsel was allowed to inquire as to what the majority had been.[75] "[W]e were six for guilty; five for not guilty; and four for not proven," came the response, clearly totaling a majority for acquittal rather than guilt.[76] The verdict of not guilty was entered as a result.[77]

This type of confusion was cause for concern on the part of judges, especially at a time when they were attempting to issue instructions explaining the not proven verdict to juries.[78] For example, in a case concerning culpable homicide, Lord Cameron instructed the jury:

> There are three possible verdicts which you can return upon this indictment. You can return a verdict of guilty of culpable homicide, as the charge is now restricted. You can return a verdict of not guilty according as you think the special defence has been made out or if you think that the Crown has failed to prove its case against the accused. You are also entitled, if that is a view which you take, to return a verdict of not proven. I confess to you quite openly and publicly that I do not ever feel happy about verdicts of not proven because, although they are strictly speaking acquittal and can be logically justified, it seems to me the honest and proper thing to do is either find a person guilty or, if the Crown has failed, to acquit them with a verdict of not guilty. But that verdict [not proven] lies open to you, and you can use it if you so wish.[79]

Appeal on the basis of misdirection was permitted because the jury was "strongly discouraged from bringing a verdict of not proven."[80] "They were, in

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73. Bill Adam, *That Bastard Verdict*, 1999 SCOT. LAW GAZETTE 159 (citing the Contempt of Court Act 1981, which makes it an offence to question juries on their deliberations).

74. *Id.*

75. *Id.*

76. *Id.* (quoting LA v. Nicholson, 1958 S.L.T. 17). Juries in Scotland may convict by a simple majority. *See* WALKER, *supra* note 14, at 529.

77. Adam, *supra* note 73, at 159-60.

78. *Id.* at 160.

79. McNicol v. HM Advocate, 1964 J.C. 25.

80. *Id.*

effect, left with only two possible choices, when in fact they should have had three."[81]

1. The Thomson Committee

The first formal consideration of the not proven verdict came in 1975.[82] Lord Thomson submitted a report entitled *Criminal Procedure in Scotland (Second Report)* to Scotland's Lord Advocate and Secretary of State, to be presented to Parliament.[83] The Thomson Committee's findings "ranged over the whole of Scottish criminal procedure and supported the retention of the three verdicts."[84] The committee reviewed separately what it considered "three distinctive features of the Scottish jury," including the not proven verdict, and delivered interrelated recommendations.[85] Specifically, the committee considered abolition of the three verdict system, because "[t]he not proven verdict came in for considerable criticism from some . . . witnesses."[86]

The Committee used arguments for the abolition of the not proven verdict as the starting point for their review.[87] The first contention was that the not proven verdict was "illogical and served no useful purpose."[88] The burden of proof beyond a reasonable doubt acted as the foundation for this point of view: "[T]he proper verdict is guilty if the case is so proved: if it is not so proved, the verdict should be not guilty."[89] A second argument upon which the committee relied was that the not proven verdict is "stigmatic."[90]

In response to these concerns the committee also reviewed arguments in favor of retention.[91] In answer to the issue of irrelevancy it was pointed out that the verdict of not guilty can be construed in two ways: as meaning "not proved guilty" or as "innocent."[92] The second interpretation has a "character-clearing effect," differentiating it from a mere lack of satisfaction of proof beyond a reasonable doubt.[93] Furthermore, the concern over stigma was rebutted with the submission that if the not proven verdict were abolished, "the not guilty

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81. *Id.* Foreshadowing future review, Lord Justice-General Clyde also stated that "no convincing argument has been advanced to justify [the not proven verdict's] elimination from our law." *Id.*

82. *See* Gow, *supra* note 23.

83. SCOTTISH HOME AND HEALTH DEPARTMENT AND CROWN OFFICE, CRIMINAL PROCEDURE IN SCOTLAND (SECOND REPORT), 194-99 (1975) [hereinafter Thomson Report].

84. Ian Willock, *The Verdict Muddle – A Way Out*, SCOLAG J., Jan. 1993, at 5.

85. Thomson Report, *supra* note 83, at 194.

86. *Id.*

87. *Id.*

88. *Id.*

89. *Id.*

90. *Id.*

91. *Id.*

92. *Id.*

93. *Id.* The committee was not willing to "go so far" as to flatly agree with this contention, although it admitted that the concept did affect their reasoning to some extent. *Id.* at 195.

verdict would acquire a stigma which it does not have."[94] Additionally, the argument was made that "if juries were faced with a straight choice between guilty and not guilty, they would in some cases return verdicts of guilty where they would have found the case not proven if that verdict had been open to them."[95]

In making their recommendation to keep the three verdict system, the Thomson Committee, "[i]n fairness to the accused . . . prefer[ed] to retain the not proven verdict."[96] They made clear that there was "no evidence that the public regard the present system as working unsatisfactorily," and that they did not "wish to make any recommendation which might possibly have an adverse result."[97] The Committee also stated that the criticism that two acquittal verdicts is illogical may be founded on the fact that few judges distinguish them from each other.[98] However, the Committee was also quick to point out that the "wisest and certainly the safest course for a judge to follow" is not to attempt to draw a distinction between not proven and not guilty in directions to the jury.[99]

This advice was put into practice for more than a decade following the Thomson Committee's report, as evidenced by the cases of *McDonald v. HM Advocate* and *Fay v. HM Advocate*, where the sentiment that judges should exercise restraint in charging the jury was reiterated.[100] In *McDonald*, like *McNicol* before it, the issue on appeal was the instruction given to the jury regarding the differences among the three verdicts:

> You say where does not proven come, well where indeed? It is not easy to define the not proven verdict . . . . [I]f the not proven verdict was not available your verdict almost certainly would be guilty . . . . You have a niggling concern at the back of your mind that you do not want to let the accused person free and without stain on his character, yet you are unhappy about the quality and standard . . . of the Crown['s] evidence.[101]

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94. *Id.* at 194.

95. *Id.* at 195.

96. *Id.* at 195. The recommendation was not unanimous, however, because three committee members remained opposed to retention of the not proven verdict on grounds that the report was a "formal recognition of what might be described as first and second class acquittals." *Id.* at 195.

97. *Id.* at 197. "It almost goes without saying that the Committee possessed no information whatsoever about the way in which the not proven verdict was understood and used by juries." Duff, *supra* note 13, at 7.

98. Thomson Report, *supra* note 83, at 195.

99. *Id. See also* McNicol v. HM Advocate, 1964 J.C. 25.

100. McDonald v. HM Advocate, 1988 J.C. 74; Fay v. HM Advocate, 1989 J.C. 129.

101. *McDonald*, 1988 J.C. 74. Sheriff Fraiser claimed that his direction was "quite deliberate" and was one that he had "commonly given," having derived it from the comments of Lord Justice-General Clyde in *McNichol*. *Id.*

The resulting convictions were quashed, and the court allowed an appeal because the "direction on the not proven verdict was a misdirection."[102] Furthermore, Lord Dunpark stated that the sheriff "would be well advised to stop giving [such jury instructions]," because it is "highly dangerous to . . . endeavor to explain what the not proven verdict is in relation to the not guilty verdict."[103]

The effects of *McDonald* perpetuated ignorance on the part of the public, specifically jury members,[104] and resulted in a "positive disinclination on the part of the judiciary to provide any sort of direction on the applicability of the verdict and, by way of precedent, to sheriffs and judges hearing subsequent trials."[105] Less than a year later in *Fay*, after a direction for the jury to find "not guilty" if they decided the accused was innocent, counsel argued that the necessary implication was that "not proven" applied where the jury considered the accused not innocent.[106] The court held the argued implication erroneous, and suggested that if the sheriff had been aware of the decision in *McDonald*, perhaps he would not have "attempted to draw the distinction between these two verdicts."[107] Ultimately, the court found that no miscarriage of justice had resulted, and the appeal was denied.[108]

Some, however, did not agree with limiting the instruction concerning the two acquittal verdicts.[109] In his commentary on *Fay*, Sheriff Gordon expressed that "[e]ither there is a statable [sic] difference between not proven and not guilty, in which case the jury are entitled to be told what it is, or there is no such difference between them, in which case one of them should be abolished."[110]

2. *Amid the Muddle*[111]

Perhaps because the contradictions among the three verdicts had become more glaring, during the early 1990s, the not proven verdict again came under scrutiny, while the Thomson Committee's report lost following.[112] One

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102. *Id.*

103. *Id.* "[T]he normal direction is to say you have three verdicts, one of guilty and two alternative acquittal verdicts of not guilty or not proven[,] and to say to the jury the choice is theirs because they are both acquittal verdicts." *Id.* "[J]urors generally received no guidance whatsoever on how they should differentiate these two verdicts." Duff, *supra* note 13, at 6.

104. *See* Adam, *supra* note 73, at 159.

105. *Id.* at 160.

106. Fay v. HM Advocate, 1989 J.C. 129.

107. *Id.* The court does point out that "[i]n fairness to the sheriff . . . the decision in McDonald was not reported until after the date of the trial in the present case." *Id.*

108. *Id.*

109. *See* Willock, *supra* note 84.

110. *Id.*

111. *Id.*

112. *Id.*

example of this is found in *Larkin v. HM Advocate*,[113] concerning jury instructions like *McNicol* and *McDonald*. The sheriff's charge was:

> On the evidence which we have heard, you will be quite entitled to find each of them guilty; again on the evidence which you have heard, you would be quite entitled to find each of them not guilty; and again it may be that the words "not guilty" might just stick in your throats and you could not bring yourselves to utter them but nevertheless felt the charges have not been proved fully to your satisfaction, then again, if that was so, a verdict of not proven would be appropriate.[114]

In sharp contrast to previous cases, the court held that the sheriff "was doing no more than telling the jury of the place which the not proven verdict occupies in our legal procedure."[115] It was inferred from this case that appellate judges were "ready to countenance the older practice" of drawing a distinction between the two acquittal verdicts in jury instructions, which had been criticized since the Thomson Committee report.[116]

Another reason for the scrutiny of the not proven verdict was several cases where the verdict "caused great dissatisfaction and feelings of injustice from members of the victim's family."[117] One such case involved a 19-year-old charged with stabbing another teenager to death during a gang fight, and who was acquitted after a not proven verdict.[118] Another involved the acquittal of a man charged with murdering a taxi driver by stabbing him through the heart with a hunting knife.[119] A third case, the sexual assault and murder of a nineteen-year-old student named Amanda Duffy, also resulted in the accused, Francis Auld, going free after a verdict of not proven.[120]

Well publicized and arousing considerable public controversy, the verdict in the Duffy case was perhaps the most politically significant.[121] Most observers were astonished by the verdict, because "[t]he impression given by the media was that the accused had indeed committed the crime."[122] The "considerable forensic evidence"[123] seemed overwhelming: a bite mark on Duffy's breast was shown to have been inflicted by Auld; a clump of hair found near the body was matched to Auld's; and Auld's alibi was not corroborated.[124]

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113. Larkin v. HM Advocate, 1993 S.C.C.R. 715.
114. *Id.*
115. *Id.*
116. Ian Willock, *Not Proven*, SCOLAG J., Sept. 1993, at 142.
117. Gow, *supra* note 23.
118. *Id.*
119. *Id.* (discussing Mullan v. Anderson, 1993 S.L.T. 835).
120. *Id.*
121. Duff, *supra* note 13, at 7.
122. *Id.*
123. Alistair Bonnington, *Private Prosecutions*, 145 NEW L. J. 1105 (1995).
124. Adam, *supra* note 73, at 159.

The impression given by police was that the matter was closed, as far as they were concerned.[125]

This case, as well as the others in which a "seemingly incomprehensible not proven verdict had been returned, led to the 'Abolish the Not Proven Verdict Campaign'."[126] Duffy's parents organized a petition within weeks of the decision.[127] The petition quickly carried approximately 38,000 signatures and was "circulated nationally throughout Scotland."[128] One commentator stated that it was somewhat odd that this "populist movement" should be "complaining that the acquitted accused has been denied the verdict of not guilty and in the eyes of many people leaves the court under a cloud of suspicion."[129] He went on to say that "the point the campaigners are making is well taken .... 'We have got three verdicts in Scotland and two of them mean the same thing.'"[130]

Early in the campaign, the Duffys secured the assistance of George Robertson, their representative Member of Parliament (MP).[131] This not only helped their cause gain further momentum, it also allowed it to "climb the political agenda"[132] when Robertson introduced a private member's bill to abolish the not proven verdict.[133] Robertson said that the verdict was "equally unfair to the accused, for whom it is seen as 'guilty but not enough proof,' and the victim and victim's family, who are left only with a question mark and no resolution of a crime."[134] The political pressure became enough for the Lord Advocate, the senior law officer in Scotland, to reveal that he felt some "unease" about the not proven verdict.[135] He also suggested that "if one were designing a legal system from scratch, one would not incorporate a three verdict system."[136] The Scottish Office made a statement at the same time as the Lord Advocate, saying that it "'was not convinced that there was enough groundswell of dissatisfaction from the public and, crucially, from the legal profession' to justify any scrutiny of the not proven verdict."[137]

Less than two months later, following and fueling the public's outcry, British Broadcast Company (BBC) Scotland devoted a documentary television program to the issue.[138] They also commissioned a public opinion poll.[139] Of

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125. Duff, *supra* note 16, at 195.
126. Adam, *supra* note 73, at 159.
127. Duff, *supra* note 13, at 7.
128. Gow, *supra* note 23.
129. Willock, *supra* note 84.
130. *Id.* Willock also suggests, "They have obviously been well instructed by their lawyers and find what they have been told incomprehensible." *Id.*
131. Duff, *supra* note 13, at 7.
132. Gow, *supra* note 23.
133. Duff, *supra* note 13, at 7.
134. Gow, *supra* note 23.
135. Duff, *supra* note 16, at 195.
136. Duff, *supra* note 13, at 8.
137. *Id.* at 8-9.
138. Duff, *supra* note 16, at 196. The documentary program, entitled *Not Proven: That*

those questioned, "48 per cent . . . [erroneously] believed that, after a verdict of not proven, the accused could be retried on the same charges if fresh evidence emerged.[140] A further 11 per cent simply did not know the consequences of such a verdict."[141] As such, it appeared that "60 per cent of the Scottish public—and, consequently, potential and actual jurors—simply did not understand the not proven verdict."[142]

Days after the BBC documentary aired, Robertson secured a meeting with the Secretary of State for Scotland, Ian Lang, to discuss his private member's bill for abolition of the not proven verdict.[143] A week later, having garnered approximately 60,000 names, the Duffy family presented their petition to the Scottish Office.[144] The next day, in a turn-around from the position taken two months earlier, Lang announced a "wide-ranging review" of the Scottish criminal justice system and made a "surprise pledge" to include "scrutiny of the not proven verdict along with various other aspects of trial by jury."[145] It was touted as "the biggest review of the criminal justice system north of the border [with England] in nearly 20 years."[146]

3. *Improving the Delivery of Justice in Scotland*[147]

"[D]espite the fact that the question of the not proven verdict was clearly tangential to the main thrust of the review, the debate over the three verdict system overshadowed all the other matters under consideration" by the Scottish Office.[148] The starting point for the review was actually the "perceived waste of time by civilian and police witnesses waiting to be called,"[149] and the "primary motive . . . was to cut costs and increase efficiency."[150] Four consultation papers were published in preparation for the review, the third of which was the

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Bastard Verdict, was "essentially hostile to the retention of the three verdict system," and featured the Duffy case and Robertson. Duff, *supra* note 13, at 9.

139. Duff, *supra* note 13, at 9.

140. *Id.* "This is indicative of the failure of the lawyers in court to get the proper message across to the 15 people who make up a Scots criminal jury." Alistair Bonnington, *The Jury – A Suitable Case for Treatment?*, 145 NEW L. J. 847 (1995).

141. Duff, *supra* note 13, at 9.

142. *Id.* "There was no difference in knowledge between those who had been on a jury and those who had not." *Id.*

143. *Id.*

144. *Id.* The Duffy family also brought a civil case for damages against Auld, a fairly rare event in Scotland. *See* Bonnington, *supra* note 123. In this "second line of prosecution" the standard of proof is "balance of probabilities" [similar to more likely than not] as compared to "beyond reasonable doubt." *Id.* The pleadings "quite openly accus[ed] him" of their daughter's killing, and Auld was advised not to defend the case. *Id.*

145. Duff, *supra* note 13, at 10. By coincidence, the Scottish Office had been planning the review during this same period, entitling it "Improving the Delivery of Justice in Scotland." *Id.*

146. *Scottish Review*, L. SOC'Y GAZETTE, June 2, 1993, at 7.

147. *See supra* note 145.

148. Duff, *supra* note 13, at 10.

149. *From the Editor – Criminal Justice on Trial*, 38 J. L. SOC'Y. SCOT. 286 (1993).

150. Duff, *supra* note 13, at 10.

only one "not primarily concerned with issues of cost and efficiency."[151] Entitled *Juries and Verdicts*, it raised several issues affecting the jury system, although "the bulk of the paper—six out of [twelve] chapters—was devoted to the not proven verdict."[152] The purpose of this consultation paper was not to express an opinion on the future of the three-verdict system, but to simply canvass the arguments for abolition or retention and invite the submission of views from the public.[153]

In light of the public movement to abolish the not proven verdict, the Scottish Office introduced *Juries and Verdicts* with a "unifying theme": "[A] high priority to maintaining the quality of our system of justice and recognis[ing] that, to achieve this, it is essential that the system must have the support of the public at large."[154] As with the Thomson Committee report of 1975, it is "interesting to note the importance apparently attached to public opinion, for that, of course, is precisely the audience with which trial by jury is primarily concerned."[155] This assertion is based on the idea that the jury "performs an ideological or symbolic role in the criminal justice process" that may be "more significant than the impact the jury has in practice."[156]

From a practical standpoint, the "question of what verdicts are available and how they should be used must be of substantial interest to citizens who are asked to serve on juries."[157] Yet, the Scottish Office did not hesitate to point out that "[t]here is no statutory, case law or generally accepted definition of the not proven verdict, nor of the difference between not proven and not guilty."[158] Furthermore, the consultation paper did not take a position on the issue of the directions to juries.[159] Regardless of this lack of definition, at the time of *Juries*

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151. *Id.*

152. *Id.* at 10-11.

153. *Id.* at 11.

154. JURIES AND VERDICTS, *supra* note 28, at 5.

155. *See* Duff, *supra* note 13, at 7.

156. *Id.* at 1. In Scotland, fewer than one percent of those brought to trial in a criminal court have a jury. *Id.* Duff proposes that "what [the jury] achieves in the realm of ideology" is most important:

> [I]t represents to the public an adherence by the state to a mélange of aims and ideals which buttress, in particular, the legitimacy of the criminal justice system and, in general, the democratic system of government. The jury acts primarily as a symbol: it symbolizes impartial and independent decision making in the criminal justice process; and, in the broader context, it symbolizes community representation and participation in the process of government. Through its ideological role, the jury helps obscure the reality of the criminal justice system which primarily involves the routine processing of large numbers of guilty pleas through the lower courts. In essence, therefore, the jury acts primarily as a flagship or showpiece for the criminal justice system.

Id. at 2.

157. JURIES AND VERDICTS, *supra* note 28, at 6.

158. *Id.* at 29. "The most common popular explanation," it says, "is that not guilty means that the accused did not commit the crime, whereas not proven means that there was a reasonable doubt as to whether he did commit the crime." *Id.*

159. *Id.* at 30.

and Verdicts, usage of the not proven verdict accounted for twenty-one percent of acquittals.[160] Juries tended to "make proportionately more use of the not proven verdict," returning it in a higher percentage than sheriffs and justices alone.[161]

The Scottish Office also hoped to clear the air by responding to "misconceptions" the public had concerning the not proven verdict.[162] Their expectation was that erroneous views about the "nature and effect of the [not proven] verdict"[163] would be corrected by *Juries and Verdicts*.[164] First, clarification was given concerning the issue of double jeopardy, pointing out that it would be "unfair and oppressive" to "bring fresh proceedings when a court has decided that [the Crown] has failed to bring its case."[165] Additionally, perhaps in answer to the attitude displayed by police in the case of Amanda Duffy,[166] it was put forth that the not proven verdict does not "prevent anyone else [from] being convicted for [the same] crime."[167] Lastly, the Scottish Office contended that the not proven verdict was not a "soft option" allowing juries to "avoid their duty to reach a clear verdict" when they were "reluctant to convict," because it is a "clear decision to acquit" and "is in its effects the same as a not guilty verdict."[168]

With these issues aside, the debate over the not proven verdict began again, enlarged since the Thomson Committee's report, and with the purpose of the government welcoming views on whether to retain the three verdict system.[169] Abolitionists' concerns over the presumption of innocence were

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160. *Id.* at 27.

161. *Id.* However, "because of the far greater number of summary prosecutions, 88% of not proven verdicts are returned by sheriffs or justices sitting alone." *Id.*

162. *Id.* at 31.

163. *Id.*

164. Duff, *supra* note 13, at 11; *see also* SCOTTISH OFFICE, FIRM AND FAIR: IMPROVING THE DELIVERY OF JUSTICE IN SCOTLAND 19 (HMSO, Edinburgh Press 1994) [hereinafter FIRM AND FAIR]. Duff considers this a "rather unrealistic view," stating, "Obviously, such statements amount to no more than wishful thinking; the bedtime reading of the Scottish public—and, thus, potential jurors—is hardly likely to include Scottish Office consultation papers on criminal justice." Duff, *supra* note 13, at 11.

165. JURIES AND VERDICTS, *supra* note 28, at 31. Almost patronizingly, the Scottish Office states that "this has been the rule for as long as criminal proceedings have been documented in this country." *Id.*

166. *See* Duff, *supra* note 16, at 195.

167. JURIES AND VERDICTS, *supra* note 28, at 31.

168. *Id.* at 32. The acquitted "are not subject to any sanctions, restrictions on their liberty or loss of rights. Since they have not been proved guilty they should be presumed innocent." *Id.* at 35. "If the not proven verdict were not available, then in logic juries should choose not guilty in its place." *Id.* at 32. However, logic is not always the deciding factor where a jury may find that "the law needs to be tempered with mercy." Duff, *supra* note 16, at 195. For example, a jury may know "perfectly well the accused is guilty [but], it is not prepared to convict in [a] particular case." *Id.* This provides the jury with "a rather subtle way of 'nullifying' the law instead of having to confront it directly and openly." *Id.* *Cf.* discussion *supra* Part II.A.4 (discussing early cases in which the jury avoided imposing a guilty verdict).

169. JURIES AND VERDICTS, *supra* note 28, at 37.

addressed directly.[170] The Office suggested that the not proven verdict is consistent with this presumption because a "trial is held to establish whether the Crown's case is proved beyond reasonable doubt," and "not necessarily [to] provide an opportunity for an accused person to establish his innocence."[171] "It is only in any social stigma" it was acknowledged, "that this presumption may be weakened."[172]

In this regard, the criticism that the not proven verdict "leaves the character of those who are subject to it stained in some way" was cited as one of those "most consistently expressed."[173] While admitting that "[i]n some cases reporting of the evidence against the accused clearly does stigmatise him whatever the verdict," and that "two different acquittal verdicts may increase the possibility of stigma," the Office believed that it was "not necessarily a conclusive argument against the three verdict system."[174] A more powerful argument concerned the "lack of clarity and scope for confusion" acting as a disadvantage to the three-verdict system.[175] Instead of promoting ignorance like the Thomson Committee, the Scottish Office claimed it was unsatisfactory for juries and judges to use an unexplainable verdict, without criteria for choosing between the two acquittals.[176]

The effect on victims and their families was also discussed, perhaps another reference to the case of Amanda Duffy and its aftermath.[177] The Office recognized that trauma could be eased by a conviction, or could be exacerbated by acquittal.[178] "However, it is not clear that the returning of a not proven verdict is any more unsatisfactory for the victim and family than a not guilty verdict," which "would be the logical alternative."[179]

Juries and Verdicts also covered the arguments in favor of retention.[180] The "principle justification" listed for having a third verdict was that "it provides an additional outlet for reasonable doubt."[181] The not proven verdict was considered a "safeguard which allows judges and juries to express their reasonable doubts in a manner acceptable to them," rather than deciding guilt

170. *Id.* at 35. "The usual reason given for abandoning not proven is that it is incompatible with the presumption of innocence. But it should be stressed that that is a gloss on the burden of proof which lies throughout on the Crown." Willock, *supra* note 84.

171. JURIES AND VERDICTS, *supra* note 28, at 35.

172. *Id.*

173. *Id.*

174. *Id.* at 36.

175. *Id.*

176. *Id.* Perhaps because it was "born in a collective moment of total belief in a man's innocence, [the not proven verdict] has never been allowed to fully develop. Unless sheriffs and judges are allowed to give opinions on what it means and when it is applicable it never will." Adam, *supra* note 73, at 160.

177. *See* JURIES AND VERDICTS, *supra* note 28, at 36.

178. *Id.* at 36.

179. *Id.* at 36-37.

180. *Id.* at 33.

181. *Id.*

on the basis of not wanting to assign innocence.[182] Secondly, and more esoteric, the Scottish Office said, "the availability of the not proven verdict is a pragmatic recognition of reality."[183] It "evolved from the will of the people and is in keeping with the common law foundation of much of Scotland's criminal justice system."[184]

Although denying a connection in law between the Scottish requirement for corroboration of evidence[185] and application of the not proven verdict, the Office did suggest that concerns over the credibility of victims and witnesses were important.[186] One implication drawn was that the not proven verdict "is a more satisfactory verdict for the victim and others . . . because it can reflect the absence of the necessary proof without casting doubt on the honesty or reliability of the victim."[187]

In the conclusion of *Juries and Verdicts*, the Scottish Office presented the choice of a two verdict system: guilty and not guilty as opposed to proven and not proven.[188] It proposed that objections to the not proven verdict could also support the abolition of the not guilty verdict.[189] "There is an argument that the available verdicts should be proven and not proven since this reflects the real purpose of criminal trial which is to establish whether [the case is proved] beyond reasonable doubt and not to prove guilt or innocence per se."[190] The benefit of being found not guilty, which would lessen stigma and support the perception of presumed innocence, was a factor in favor of using the guilty/not guilty verdicts.[191]

The result of the paper, as anticipated, was an enlivened debate over proposals to improve the three-verdict system of jury trials in Scotland.[192] One barrister said, "There is no real place for having two separate verdicts of acquittal . . . . If there is full and proper argument, it is [difficult] to justify retaining the verdict."[193] Another stated that the value of the not proven verdict

182. *Id.* "This third alternative is also considered to be a valuable safeguard against unjustified verdicts of not guilty." Linda Tsang, *Separate Verdicts*, LAWYER, June 27, 1995, at 16.

183. JURIES AND VERDICTS, *supra* note 28, at 33.

184. *Id. See also supra* note 156 (discussing the connection between the public and jury trials).

185. *See* WALKER, *supra* note 14.

186. JURIES AND VERDICTS, *supra* note 28, at 33.

187. *Id.* at 33-34. "This advantage is particularly relevant to serious sexual offences where it may be that the victim is the only witness and there may be insufficient corroboration." *Id.*

188. *Id.* at 38.

189. *Id.* "Indeed, to straighten out the whole mess the guilty verdict should be replaced with 'proven.' That would be a departure from common usage in the rest of the English speaking world, but it would make manifest to it the independent and logical outlook of Scots law." Willock, *supra* note 84.

190. JURIES AND VERDICTS, *supra* note 28, at 38. This choice would also reflect seventeenth-century history. *See* discussion *supra* Part II.A.2.

191. JURIES AND VERDICTS, *supra* note 28, at 38.

192. *Id.* at 5.

193. *See* Tsang, *supra* note 182 (quoting Gordon Jackson, QC).

was that "when the jury is confronted by evidence of varying types and characters, it can return a verdict which more closely reflects their view of the case .... It enables a jury to concentrate on the quality of the evidence they are there to determine."[194]

Sir Nicholas Fairbairn, Queens Counsel (QC) and Member of Parliament, also added his two pence, because "the Lord Advocate has asked for comment."[195] He considered the verdict "not a let out verdict as is often claimed," but rather "the proper verdict where the jury are not satisfied beyond reasonable doubt but cannot say not guilty."[196] "So what is wrong with a ranch of verdicts which provide for all situations?" he asked, answering: "Nothing I can see, so I find the case against not proven, not proven. Long live 'Not proven.'"[197]

The Scottish Office agreed, and kept the not proven verdict.[198] In June of 1994, the government published a White Paper entitled *Firm and Fair*,[199] derived from the responses to the four prior consultation papers, including *Juries and Verdicts*.[200] Although the Scottish Office determined that Scotland was "well served by its distinctive system of criminal justice," it was clear that a "substantial overhaul" through "significant reforms" was to take place.[201] "We have taken careful account of [the replies to the consultation papers]," the Secretary of State for Scotland wrote, "and they have helped to shape proposals in this White Paper. Our aim is to produce a system which is fair to all – to victims, to witnesses and to society at large, as well as to the accused."[202]

Even so, of approximately seventy proposed changes, no plans were included for altering the three-verdict system.[203] The Office explained that the three-verdict system should not be altered or abolished lightly, at the same time it should not be maintained out of tradition.[204] To split the difference, the

194. *Id.* (quoting Donald Findlay, QC). While the debate was happening, in 1993 the not proven verdict was brought 1,515 times (approximately one percent of scheduled trials), and ten times out of 118 for murder. *Id.*

195. Sir Nicholas Fairbairn, *The Not Proven Verdict*, 37 SCOT. L. TIMES 367, 367-68 (1994). He prefaced his comments by saying that "the reasons for the assaults upon [the not proven verdict] are that it is different and thoughtfully civilised." *Id.*

196. *Id.*

197. *Id.* at 368.

198. *See* Duff, *supra* note 16, at 196.

199. *See* FIRM & FAIR, *supra* note 164.

200. Duff, *supra* note 13, at 11.

201. FIRM AND FAIR, *supra* note 164, at v.

202. *Id.* The Secretary of State for Scotland also emphasized:

> We must have a criminal justice system which works, and is seen to work, well. It must be understood by those who pay for it, and who look to it to protect them, their families and the communities in which they live .... It is essential that the Scottish criminal justice system commands respect and public confidence.

Id. at v, vi. This supports Duff's view of the symbolic importance of the jury. *See supra* note 156.

203. Duff, *supra* note 13, at 11.

204. FIRM AND FAIR, *supra* note 164, at 19.

Office sought "a consensus for change" among the public or the legal profession, which the responses to the consultations had not revealed.[205] For example, responses were divided as to the logic of the not proven verdict, with some supporting the view that three verdicts were "more consistent with reality than a two verdict system."[206] Without "a considerable weight of informed opinion against the verdict" the Office retained it.[207]

Yet the debate continued among the public, as well as the members of the House of Commons.[208] A year after *Firm and Fair*, John Home Robertson, Member of Parliament for East Lothian, proposed that "[i]n any criminal proceedings the verdict of not proven shall no longer be competent," and pushed for a vote on the issue.[209] "I cherish Scotland's institutions and its traditions, and perhaps our national idiosyncrasies, but it is abundantly clear to me that this particular example [the not proven verdict] is far more bother than it is worth," he said, continuing, "It is making real mischief and devaluing the quality of Scottish justice."[210]

Robertson's main concern with the verdict, which he considered a "comprehensive cop-out," was the "indelible smear" it leaves on the character and record of the acquitted person.[211] "In theory, he has been acquitted, but it is fair to assume that his reputation is blemished, and that his career is likely to be affected . . . . He is not guilty but, after that verdict, he is not innocent, either."[212] Robertson also termed the verdict a "grudging acquittal" for which there is no logical basis, because "[i]t simply creates the odd phenomenon of either qualified innocence, which carries a stigma . . . or qualified guilt, which carries no penalty."[213] It was this anomaly he wanted addressed in a way more satisfying than the review culminating in *Firm and Fair*.[214] "The not proven verdict may be a rather quaint Scottish tradition, but I submit that nostalgia cannot be a sound basis for good justice," he concluded.[215] "The not proven verdict is a device for sidestepping justice and has been tolerated for far too long . . . . It is a formula which should be consigned to history."[216]

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205. *Id.* *See also* Duff, *supra* note 16, at 196.

206. FIRM AND FAIR, *supra* note 164, at 19; *see also* JURIES AND VERDICTS, *supra* note 170.

207. FIRM AND FAIR, *supra* note 164, at 19. This echoes the Thomson Committee's conclusion. *See supra* note 97 and accompanying text.

208. Hansard, *supra* note 25, at 219.

209. *Id.* He was hopeful that the House of Commons would address the problem, realizing that "[t]he House is the only place where it can be addressed until such time as we have a Scottish Parliament." *Id.* at 237.

210. *Id.* at 219.

211. *Id.*

212. *Id.* at 237.

213. *Id.*

214. *Id.* Of the prior review, he noted: "It looks to me as if the Government [has] copped out of the opportunity to deal with Scotland's cop-out verdict." *Id.* at 221.

215. *Id.* at 220.

216. *Id.* at 220-21.

George Robertson, Member of Parliament for Hamilton, who was involved with the Duffy family's petition from its early stages, had strong personal views on the subject.[217] His main argument addressed the confusion resulting from the three verdicts, which he believed led to an "undermining of faith in the Scottish criminal justice system" even after *Firm and Fair*.[218] As emblematic of that confusion, he set forth the formal titles of the verdicts, different from those understood by the general populace: "Acquitted Not Guilty, Acquitted Not Proven, Charge Proved."[219] "If there is such confusion about the terminology of the verdicts in the courts," he said, "it is not surprising that there is some confusion among the general population."[220]

He also pointed to the lack of instruction for jurors. Because the "sheriffs or judges often do not make clear the differences between the three verdicts. . . . it is scarcely surprising that members of the public, as well as jury members, are confused."[221] Such confusion "cannot be good for the reputation, integrity and efficacy of the criminal justice system in Scotland."[222] Robertson summed up his position by asking, "Who at the end of the day is still in favour of three verdicts in the Scottish courts:"[223]

> Not the victims, who are left hanging in the air of frustration and mystery that comes at the end of a trial when a not proven verdict is handed down. Certainly not the recipient, unless he or she was guilty and is relieved at having been acquitted, because the recipient is left with a stigma, which . . . is impossible for him or her to clear. The system cannot be satisfied with a situation that undermines the presumption of innocence. The public, who are at best confused by, and at worst hostile to the idea of the not proven verdict, certainly are not in favour of having three verdicts. The legal profession may well be, especially those who are in criminal cases on the defence side, because it is an entirely suitable deployment of their skills to go for three verdicts instead of just two. Those who were clearly guilty but feel that they have got off could be in favour of it as well . . . . [J]uries who do not want to take a straightforward decision based on the case that has been put before them will be pleased to have three verdicts in Scottish courts.[224]

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217. *Id.* at 228.
218. *Id.* at 229.
219. *Id.*
220. *Id.*
221. *Id.*
222. *Id.* at 230.
223. *Id.* at 234.
224. *Id.* at 234-35.

On balance, he considered these to be "a sufficient strength of opinion to weigh against the arguments" for retaining the not proven verdict.[225]

But other Members of Parliament, such as Malcom Chisholm of Edinburgh/Leith, voiced opposition to abolishing the not proven verdict.[226] He did so with what he considered the "majority of informed opinion in Scotland," including "the massed ranks of the judges of Scotland, the Law Society of Scotland, the Faculty of Advocates, the Scottish Council for Civil Liberties and the rape crisis centres and victim support organizations in Scotland," as well as the Scottish conference of the Labour party.[227] One point he argued was, "[i]f we were to get rid of everything that is confusing in the Scottish legal system, we would dismantle quite a lot."[228]

Menzies Campbell, MP of Fife North-East, suggested that such a dismantling would have "profound and far-reaching consequences" though it may seem right superficially.[229] Relying on *Juries and Verdicts* and *Firm and Fair*, he posited that the criticisms of the verdict were based on misconceptions of its nature and effect.[230] Rather than viewing it simplistically, Campbell stressed that "the not proven verdict . . . is a sophisticated verdict in a sophisticated legal system."[231] As such, "[t]he circumstances in which it is most appropriate may not be capable of scientific prediction, but the law is not an empirical but a normative discipline."[232] In this way "[t]he verdict allows juries and [judges] to express a shade of meaning concerning an acquittal different from what they believe would be justified by the use of the words 'not guilty'."[233] He further argued that "[a]ny alteration . . . cannot be considered in isolation . . . . [A]part from the merits of the verdict, one must have regard to its consequences."[234] For example, in a system where an eight to seven vote results in conviction, "the not proven verdict is an important protection in cases in which a simple majority would be sufficient."[235]

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225. *Id.* at 235.
226. *Id.* at 224.
227. *Id.*
228. *Id.* at 225.
229. *Id.* at 221.
230. *Id.*
231. *Id.* at 222. He also states:

> I understand the occasional outpouring of grief[,] of anxiety, or even outright anger, that arises when a not proven verdict is returned, but sympathy and understanding of those emotions should not blind us to the fact that, in serious cases, decisions about guilt and acquittal are taken by the jurors empanelled for that purpose, not by the system of verdicts.

Id. at 223.
232. *Id.* at 222.
233. *Id.*
234. *Id.* at 223.
235. *Id.*

In terms of the vote by the House of Commons upon the proposition by John Home Robertson, the majority of members, 325, were for retention of the not proven verdict, while only 117 supported its abolition.[236]

III. AN OLD VERDICT FOR A NEW MILLENNIUM

A. *Scotland: Getting Off Scot Free*[237]

"History can explain, but there is no reason why it should dictate current practice, unless there are good reasons to let it do so."[238] Despite *Firm and Fair*, this sentiment beat on in the hearts of Scots lawyers who felt that "ever since its inception the not proven verdict has never fully had the benefit of . . . guidance from the common law."[239] Anticipatory optimism hung in the air prior to the year 2000:

> As we do not seem to trust the judiciary to define the verdict we may, at the dawn of a new millennium and with a new Parliament, have to think the unthinkable. We may have to ask the legislature to enter what should be the preserve of the common law and provide a workable explanation of the verdict. Ask it to enact a clear definition with which sheriffs and judges can charge juries, and direct themselves, as to when it is applicable. By doing this, and hopefully educating the general public in the process, Parliament may also be able to address the stigmatizing effect of the verdict.[240]

Instead came more of the same, the 2001 case of *Cussick v. HM Advocate*[241] for instance. Again, the appeal dealt with misdirection concerning

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236. *Id.* at 238.

237. Michael Quinion, *Scot free*, World Wide Words, Questions & Answers, *at* http://www.worldwidewords.org/qa/qa-sco1.htm (Oct. 24 1998) (last visited Mar. 24, 2005).

> As with the word hopscotch, scot free has no connection with Scotsmen, frugal or otherwise. It's a Scandinavian word meaning "payment". The expression derives from a medieval municipal tax levied in proportional shares on inhabitants, often for poor relief. This was called a scot, as an abbreviation of the full term scot and lot, where scot was the sum to be paid and lot was one's allotted share . . . . So somebody who avoided paying his share of the town's expenses for some reason got off scot free.

Id.

238. Willock, *supra* note 84.

239. Adam, *supra* note 73, at 160.

240. *Id.* He continues that developing a working definition may be an impossible task for the Scottish Parliament, since sheriffs and Lord Justice-Generals have tried without success. *Id.* Instead, he suggests that Parliament may have to "think another unthinkable" and "contemplate abolishing 'that bastard verdict!'" *Id.*

241. 2001 S.L.T. 1316.

use of the not proven and not guilty verdicts.[242] Attempting to differentiate between the two, the sheriff said that not proven could be brought if guilt had not been established, but that not guilty would result if the accused had "exculpated themselves from the charge," clearly undermining the presumption of innocence.[243] The court stated that it had "repeatedly discouraged" such attempts at explanation, and finding it "liable to confuse the jury," quashed the conviction.[244]

A similar situation rekindled the debate in 2002, when a woman requested that her drugs conviction be overturned based on misdirection.[245] Once again, the logic of the three-verdict system came under scrutiny.[246] The dynamics of the argument shifted a degree, however, and seemed more intense than during the consultation paper of a decade earlier, though still geared toward an either/or preference for two verdicts: "'Guilty/Not Guilty' can be justified in logic, as can 'Proven/Not Proven.' 'Guilty/Not Guilty/Not Proven' cannot."[247] Commentators scoffed at the idea that "this [was] just a minor legal technicality."[248] "The verdict is not a mere frill or an appendage to the criminal law in Scotland. It is the business end of the criminal justice system and everything that happens is intended to lead to it."[249] Any leftover pre-millennial optimism dissipated, leaving only blunt logical impatience: "The three verdict system is not evidence of Scots canniness which the rest of the world would do well to copy, but a national embarrassment. The Scottish Parliament should scrap it now."[250]

The response, more measured in tone, also showed a slight shift in logic, turning the either/or argument against itself.[251] It largely posited that the not guilty verdict, rather than the not proven verdict, is "wholly inappropriate" because it "confuses absence of guilt with absence of proof of guilt."[252] Furthermore, "the issue is not Guilt or Not-Guilt," and "[i]nnocence is not an

242. *Id.* at 1319.

243. *Id.* The less than convincing excuse the sheriff gave was that in a preceding trial he had found the jury's verdict perverse, so had changed the directions. *Id.*

244. *Id.* at 1319-20.

245. *See* Bennett, *supra* note 46 (discussing Sweeny v. HM Advocate). The Court of Criminal Appeal restated the warning to another sheriff in 2002, criticized for attempting to draw a distinction. Bruce McKain, *Sheriff Criticised Over Jury Address*, HERALD (Glasgow), Jan. 22, 2002, at 9. One Lord hearing the case stated: "This court has repeatedly made observations on the dangers attendant on exercises such as that by the sheriff in this case." *Id.*

246. *See* Bennett, *supra* note 46, at 97. "Not even Lord Justice General Cooper, one of Scotland's greatest judges could justify it, saying in 1947: 'I should not like to offer a logical justification for the retention of the Scottish verdict of Not Proven.'" *Id.*

247. *Id.* at 98; *see also* JURIES AND VERDICTS, *supra* note 28. This statement is similar in tone to that of Sir Walter Scott's proclamation. *See supra* notes 24, 25 and accompanying text.

248. Bennett, *supra* note 46, at 97.

249. *Id.*

250. *Id.* at 98.

251. Lord McClusky, *Not Proven: A Reply*, 17 S.L.T. 148, 148-50 (2002).

252. *Id.*

issue in a criminal trial."[253] Rather, the retentionists argued that the "choice of 'Yes' or 'No' is the truly logical choice" for a jury to make.[254] For them, the question to be asked of the jury should be: "Has the prosecutor proved beyond reasonable doubt that the accused is guilty?" to which an answer of "Yes" or "No" would come, and after which the judge would make a formal finding of guilt or acquittal.[255] With one swift stroke of reasoning, this contention reverts the jury back to the limited status it held in the seventeenth century.[256] One is left to wonder how this would affect the symbolic purpose of the contemporary jury.[257]

Even still, absent such a reversion, the not proven verdict is appraised as being "very valuable in certain everyday situations."[258] For example, one such scenario would be "where the victim of a crime is accepted as fully reliable but the only corroboration is provided by evidence that is manifestly bogus."[259] The jury may acquit, delivering a verdict of not proven, thus leaving the victim untainted but rejecting the "bogus corroboration."[260]

As ever, the debate over the three-verdict system continues to concern evidence and the burden of proof.[261] More specifically, in a time when DNA is seen as the new fingerprint, technology has allowed corroboration through "[f]orensic evidence [as] part of much larger evidence . . . which can help equally or more forcefully to convict or acquit than trace evidence."[262]

The burden of corroborating evidence is nowhere heavier than in a case of serious sexual offenses.[263] It is possible in a rape case that the jury could "unreservedly accept the evidence of the woman that she was raped by the accused, but [be] unable to find any corroborative evidence . . . . A verdict of not proven more accurately shows that sufficient evidence as required by Scots law was not found," rather than that the woman was not believed.[264]

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253. *Id.* at 148. "I simply emphasise that the Crown has to prove guilt: the defence merely seek to show that there is no sufficient proof of guilt." *Id.*

254. *Id.*

255. *Id.*

256. *See supra* text accompanying notes 41-43.

257. *See supra* note 156 and accompanying text.

258. McClusky, *supra* note 251. In terms of practicality, he quotes Oliver Wendell Holmes as saying: "The life of the law has not been logic: it has been experience." *Id.* at 150.

259. *Id.* at 149.

260. *Id.*

261. *See* McClusky, *supra* note 251.

262. Brian McConnell, *Doubt and the Forensic Pathologist*, 146 NEW L. J. 627 (1996). The author's accounts of pathologists testifying in cases, sometimes aiding to secure a verdict of not proven, lends credence to the role of science in jury determinations, even if the pathologists were sometimes wrong. *Id.* As he points out, because there is "undeniably room for honest doubt in forensic pathology . . . Scots insist on two-doctor post-mortem examinations." *Id.*

263. *See* JURIES AND VERDICTS, *supra* note 28, at 34. Statistics in the consultation paper showed that a "smaller proportion of rape and sexual assault cases result in conviction than other serious crimes," with "a slightly higher proportion of acquittals" through not proven verdicts. *Id. See also supra* note 187 and accompanying text.

264. McClusky, *supra* note 251.

The possibility of the not proven verdict has also provided a justification for courage.[265] Victims of sexual assault and rape must act with considerable bravery when exposing themselves in open court, where they will have to "give evidence and be subjected to a rigorous and sometimes most unpleasant cross-examination about . . . sexual history."[266] Even if the evidence is insufficient on its own to bring down a guilty verdict on the assailant, the victim does not have to face "the horror of seeing him offered the unqualified certificate of good character to which a not guilty verdict would have entitled him."[267] An example is where a husband and wife are involved and proof remains a major obstacle.[268] A not proven verdict has been returned in at least two such recent cases.[269] It is speculated that juries may not be satisfied with proof of lack of consent by the wife, and are "operating [under] an implied presumption of consent" between husbands and wives.[270]

It is also argued that "[i]f the not proven verdict is taken away and such verdicts . . . become not-guilty verdicts, the credibility, honesty and reliability of women will be further called into question."[271] Furthermore, Scottish rape crisis organizations point out that "[i]f women know [the not proven] verdict is not available, it will not only be a serious problem for victims of rape[,] but women will be discouraged from coming forward with complaints of rape."[272] However, the view that "rape victims should be happy that such a verdict leaves a stigma behind" is tenuous.[273] This would be limited consolation if the accused is acquitted at the end of a trial,[274] even if it is a pragmatic recognition of reality.[275] Instead it is more likely that "having the cop-out [of the not proven verdict] relieves juries, especially in rape trials, of the obligation of coming to a firm conclusion on what they have heard in court."[276]

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265. Hansard, *supra* note 25, at 222.

266. *Id.* at 222-23.

267. *Id.* at 223.

268. Daniel Kelly, *The Reassessment of Rape in Marriage*, 35 J. L. SOC'Y. SCOT. 89 (1990).

269. *Id. See also Husband and Wife Rape Appeal*, 139 NEW L. J. 356 (1989).

270. *Husband and Wife Rape Appeal*, *supra* note 269.

271. Hansard, *supra* note 25, at 226.

272. *Id.*

273. *Id.* at 225.

274. *Id.*

275. *Id.* at 226.

276. *Id.* at 234. This seems to have been the case recently, when a 13-year-old rape victim was told, "There is not enough evidence to show, on the balance of probabilities, that you were the victim of sexual assault." Marion Scott, *Fury as Raped Girl, 13, Fails to Win Criminal Compensation*, SUNDAY MAIL (Scot.), Jan. 9 2005, at 23. While the girl claimed she had been "raped by a stranger on the garden path of her home," the defense argued that the girl—a virgin who had never had a boyfriend—agreed to sex. *Id.* "The jury returned a not proven verdict on the rape charge" even though the attack took place just sixty-seven days after the girl's thirteenth birthday, prior to which the attacker would have been convicted of statutory rape. *Id.* One child abuse campaigner said, "[T]his traumatised girl has been raped all over again by the system supposed to help her." *Id.* Hardly seeming content with a potential stigma imposed on

In May of 2003, the not proven verdict made its way back into Scottish newspaper headlines.[277] Tina McLeod, a former child-minder accused of murdering a child under her care by shaking him, was acquitted with the verdict in a highly emotional trial.[278] The charges came as "an entire shock to everyone around her."[279] "A jury of nine women and six men returned the verdict after hearing conflicting evidence from medical experts about how the child could have died."[280] One pediatric pathologist suggested that the boy's injuries were consistent with death from violent and repeated shaking, rather than with falling as claimed by the defense.[281]

McLeod felt "in no way inhibited by the not proven verdict," for which she sobbed a "thank you" to the jury in the courtroom.[282] "When the verdict was given, it meant to me that they believed in my innocence, that they believed in me," she said.[283] She also stated, "I do not personally feel it [the not proven verdict] has left a cloud over me. I honestly do not think it would make a difference if it had been not guilty."[284]

The dead child's parents were less content.[285] They felt that "the Scottish criminal justice system [had] failed."[286] "This verdict leaves us deeply dissatisfied because the question of what happened to Alexander remains unresolved."[287] Their words echo an argument of George Robertson, MP:

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her attacker, the victim said, "Maybe they [the jury] would have believed me if he'd stabbed me with the knife he used to threaten me." *Id.*

277. John Robertson, *Verdict That Causes Headaches for Judges – But Relief for Those Freed*, SCOTSMAN, May 27, 2003, http://news.scotsman.com/archive.cfm?id=592842003 (last visited Mar. 22, 2005).

278. *Id.*

279. *Neighbors Tell of Ordinary Mum They Knew Couldn't Murder a Child*, EDINBURGH EVENING NEWS, Mar. 8, 2003, http://news.scotsman.com/topics.cfm?tid=790&id=285952003 (last visited Mar. 22, 2005).

280. *Baby Murder 'Not Proven'*, BBC NEWS, Mar. 7, 2003, http://news.bbc.co.uk/1/hi/scotland/2830323.stm (last visited Mar. 22, 2005).

281. John Robertson, *Anger as Minder is Cleared of Child's Murder*, SCOTSMAN, Mar. 8, 2003, http://news.scotsman.com/archive.cfm?id=281962003 (last visited Feb. 16, 2005).

282. Robertson, *supra* note 277.

283. *Id.*

284. *Id.*

285. Diane King, *Where is Justice for Our Wee Boy?*, EDINBURGH EVENING NEWS, Mar. 8, 2003, http://news.scotsman.com/index.cfm?id=284952003 (last visited Feb. 16, 2005).

286. *Id.*

287. *Id.* The Grahams' dissatisfaction pushed them to take action in civil court, where they claimed McLeod was responsible for the death of their son by either a deliberate or negligent act. Susan Mansfield & Ian Johnston, *Woman Cleared of Killing Baby Pays Sum to Parents*, SCOTSMAN, Feb. 5, 2005, at 8. A settlement was subsequently reported, admitting no guilt on the part of McLeod and paid for by her insurance company. *Id.* Mrs. Graham is pursuing more than a monetary settlement, because she insists that "[i]t was never about the money." Susan Mansfield, *After Alexander Died We Wanted to Gas Ourselves to Death in Car*, SCOTSMAN, Feb. 5, 2005, at 8. She also wants "reform of the criminal justice system to prevent further suffering." *Id.* "[O]n top of Alexander dying," she said, "it was made so much worse for us by the legal system." *Id.* "A 'not proven' verdict is a terrible thing . . . [and] should not exist. . . . It just left completely open the issue of what had happened to Alexander." *Id.* Focusing on the jury, she stated:

"There is a legacy of frustration left behind by victims and their families where all that remains is a mystery. People throughout Scotland feel that the not proven verdict leaves in its wake an air of constant frustration and aggravation that cannot do the system any good."[288] The jury was so distressed by McLeod's case that, after they had returned the not proven verdict, the judge excused them from further jury service for a decade.[289]

American families faced the potential for this type of frustration in January of 2001, when a Scottish court delivered the verdicts for the accused bombers of Pan Am flight 103.[290] A panel of three Scottish High Court judges located in the Netherlands began hearing the case against the two accused terrorists in the spring of 1999, more than ten years after the plane fell to earth over Lockerbie, Scotland, killing 270 people, of which 189 were American.[291] Despite worries and criticisms over the not proven verdict, Scots remained proud of their system, hoping that when American lawyers saw it at work, even in the unusual circumstances of the Lockerbie trial, they would have confidence that justice had been done.[292]

At the time of trial, public opinion was split over the possible verdicts even though "the Scottish system does mirror the American system in many ways."[293] The Pan Am 103 case was the first time a Scottish Court sat abroad, and the first time serious criminal charges were tried by judges rather than a jury.[294] One professor of Scottish law, admittedly not knowing how strong the case was, suggested that "[i]t is probably more difficult to convict under Scottish law than American or English because there are stricter rules of evidence."[295] Even so, another professor of Scottish criminal law stated, "My guess would be that the judges would not hide behind [the not proven] verdict.

> We felt it was the easy way out for the jury. It allows them to avoid the fundamental question of guilt or innocence. They didn't have to make a decision, it was a non-decision. They should have had to make a decision and live with the consequences, as we've had to live with the consequences of their lack of decision.

Id.

288. Hansard, *supra* note 25, at 231.

289. King, *supra* note 285.

290. Marjorie Miller & Maggie Farley, *We've Learned There Is No Formula for Grieving*, L.A. TIMES, Feb. 1, 2001, at A1.

291. Marjorie Miller, *Pan Am Bombing Case May Be Difficult*, L.A. TIMES, Apr. 13, 1999, at A21. "More than 400 parents lost sons or daughters in the bombing; 46 parents lost an only child; 65 women were widowed; 11 men lost wives; more than 140 children lost a parent; seven children lost both parents." Miller & Farley, *supra* note 290.

292. Alistair Bonnington, *Scots Criminal Procedure and the Lockerbie Trial*, 11 INT'L LEGAL PERSP. 11, 28-29 (1999).

293. David E. Rovella, *Flight 103 Highlights Scots' Law*, NAT'L L. J., Apr. 26, 1999, at A1. Even so, Rovella admits that "[a]t first glance, the jurisdictional complications of the trial of those accused in the 1988 bombing . . . could give any lawyer a migraine." *Id.*

294. Miller, *supra* note 291.

295. *Id.*

If they feel the case has not been ruled beyond a reasonable doubt, they would return a verdict of 'not guilty'."[296]

Her guess turned out to be correct, the result being one verdict each of guilty and not guilty.[297] One of the family members equated the two verdicts of acquittal in his expected outcome: "I think most of us had resigned ourselves to either a not-guilty or not-proven verdict . . . . There was just not enough evidence to prove both of them were involved . . . . We accept that, and we're real happy with the guilty verdict."[298] A woman whose husband died stated that she "shook with joy and sadness when she heard the verdict on the morning news."[299]

B. American Bastardization of That Bastard Verdict

For Americans, the verdict of "not proven" was made famous that same year, prior to the case of Pan Am 103, when Senator Arlen Specter, a Pennsylvanian republican, chose it over a guilty vote during the impeachment trial of President William Jefferson Clinton.[300] Relying on the "tradition in Scottish courts," he voted not proven rather than not guilty when the roll was called for the Senate's verdict.[301]

One reason for his vote of not proven was that the Senate prohibited live testimony from witnesses, and only allowed videotaped testimony from three of the fifteen witnesses on the list from the House.[302] This limitation, he suggested, tied one hand behind the back of the House prosecutors.[303] "This is not to say the president is not guilty, but to specifically say that the charges have not been proven," he explained.[304] "My view is the Senate has done partial justice."[305]

Specter's choice of intermediacy was based on "undue restrictions" imposed on House Managers in the presentation of their case, which resulted in the hearing of only part of the evidence.[306] He knew when he cast a vote for acquittal that there was a risk of backlash from both sides of the political spectrum.[307] Still, he held to the view that:

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296. Mark Libbon, *Walsh Says He Likes Bush's Conservatism*, SYRACUSE POST-STANDARD, Nov. 28, 1999, at A10.

297. Miller & Farley, *supra* note 290.

298. *Id.*

299. *Id.*

300. Rovella, *supra* note 293.

301. *Specter Says House Failed to Prove Case*, INTELLIGENCER J. (Lancaster, PA), Feb. 11, 1999, at A1.

302. *Id.*

303. *Id.*

304. *Id.*

305. *Id.*

306. *Specter Justifies His "Not-Proven" Verdict*, PITTSBURGH POST-GAZETTE, Feb. 11, 1999, at A12 [hereinafter *Specter Justifies*].

307. Lisa Fine, *Specter Blasted for Vote in Trial*, INTELLIGENCER J. (Lancaster, PA), Feb.

> House Managers could not meet the heavy burden of proof beyond a reasonable doubt .... [O]n this record, the proofs are not present .... Given the option [of not proven] in this trial, I suspect that many Senators would choose 'not proven' instead of 'not guilty' .... The President has dodged perjury by calculated evasion and poor interrogation. Obstruction of justice fails by gaps in the proofs.[308]

Regardless of Specter's suspicions, "there was a pause of hushed murmuring on the Senate floor" when he announced his unique vote.[309]

As early as 1985, questions of how the not proven verdict developed and how it might be used in America were being posed.[310] It was seen as "useful in a system that allows conviction not by 12 unanimous jurors, as in most American states, but by a majority vote among 15."[311] "The middle option," it was suggested, "helps to focus a jury's attention on the weaknesses in the evidence."[312] Even so, it was thought that the verdict "wouldn't and shouldn't take root in America."[313] This was because "[i]ts potential for tainting some defendants would outweigh whatever value it has in springing others. Our stark choice has a virtue; jurors are given no way to proclaim that they harbor suspicions about the defendant even though they can't convict him."[314]

Curiosity about a third verdict did not abate, however, and the American Bar Association Journal reported in 1994 that a handful of criminal defense attorneys in Atlanta, Georgia, wanted not proven added to the verdict form.[315] "It's totally legitimate and well within the law," one lawyer said.[316] The Assistant United States Attorney thought otherwise: "What the defense lawyers should be seeking is not another verdict, but better, [clearer] instructions by the

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18, 1999, at A1.

308. *Specter Justifies*, *supra* note 306.

309. Fine, *supra* note 307. The responses Specter received from the public, on the other hand, were "deafening," expressing surprise and confusion. *Id.* These included: "Why don't you move to Scotland?"; "Hey Specter!!! HELLOOOOOO. We don't live in Scotland, or hadn't you heard? ... If it weren't so sad, it would be funny. I'm disgusted."; "I think you look good in kilts. You have nothing to hide under them."; "What a spineless wonder you are .... You are a coward without a conscience." *Id.*

310. John P. MacKenzie, *The Editorial Notebook; Between Guilt and Innocence*, N.Y. TIMES, Aug. 16, 1985, at A28.

311. *Id.*

312. *Id.*

313. *Id.*

314. *Id.* Another writer submits: "The Scots have given us many valuable imports, but the 'not proven' verdict is one we are better off without." Edwin M. Yoder Jr., *Ed Meese in the Twilight Zone*, WASH. POST, Aug. 1, 1988, at A13. He described the not proven verdict as "the sort of legal limbo to which juries might condemn a highlands chicken thief who had eaten the evidence he stole but was known by his peers to be guilty as all get-out." *Id.*

315. Debra Cassens Moss & Mark Curriden, *Prove It*, 80 A.B.A.J. 42 (1994).

316. *Id.*

judge to the jury."[317] The obvious prediction was an increase in acquittals, based on the fact that "[j]urors are known to compromise whenever possible, and this gives them a way out."[318]

A year later, during the trial of O.J. Simpson, the possibility of a third verdict was again raised in a case where "American jurors have freed a defendant whom they think culpable."[319] The discussion arose in part from a common refrain of jurors having just returned a not guilty verdict: the belief that "the defendant likely did something wrong, but that the prosecution didn't prove its case beyond a reasonable doubt."[320] "The usual result is disappointment for the prosecution and the victims or their survivors – and a feeling of a job half-done by jurors who know that while technically not guilty, the defendant was surely not innocent."[321]

To avoid this outcome, many jurors expressed that they had "an option other than not guilty, one which more accurately expressed their feeling that the defendants were culpable of the crimes charged, but the prosecution had not cleared the legal hurdle needed to convict."[322] "Returning a verdict of not proven in high-profile trials such as the O.J. Simpson . . . [case] might also alleviate some of the outrage, dissonance and civil angst that [attend] the troubling outcomes of such cases."[323] Nevertheless, Supreme Court Justice Antonin Scalia is wary of offering a third verdict: "I wouldn't favor it. . . . I sort of like the [current system's] clean-cut up or down."[324] Justice Scalia sees the not proven verdict as "a backhanded way to destroy a person's reputation without saying that he's guilty."[325]

That same year in California, state senator Quentin Kopp intended to "revive legislation that would allow juries a third option between 'guilty' and 'not guilty': a middle ground called 'not proven'."[326] His renewed interest came after the acquittal of O.J. Simpson, although he introduced the same legislation after the beating of Rodney King.[327] In defense of the measure's introduction, Kopp's chief of staff said that the not proven option is allowed

317. *Id.* This is an ironic suggestion considering the repeated warnings against such instruction over the not proven verdict in Scottish courts. *See* discussion *supra* Part II.B.

318. *Id.*

319. Mark I. Pinsky, *When Juries Need a 3rd Choice: Not Proven*, ORLANDO SENTINEL, Aug. 20, 1995, at G1.

320. *Id.*

321. *Id.* Pinsky says that after writing about several large criminal cases, he is aware that "one of the most common mistakes reporters make in covering such proceedings – apart from thinking they can argue cases better than lawyers – is equating acquittal with exoneration." *Id.*

322. *Id.*

323. *Id.*

324. *Id.*

325. *Id.*

326. Bill Ainsworth, *Anti-Crime Politicians Quick to Exploit Verdict*, RECORDER, Oct. 4, 1995, at 14.

327. *Id.* He said that the not proven verdict "would have mollified a good many indignant people" had it been available in the Simpson case. *Id.*

and works well in Scotland.[328]

However, the American Civil Liberties Union opposed the legislation in order to avoid confusing jurors and judges with a new instruction after two-hundred years of guilty or not guilty.[329] They also stated that the change would "stand the presumption of innocence on its head, because it fosters the perception that everyone charged with a crime and brought to trial is a little bit guilty."[330] Essentially, it was argued that "once released, a person found 'not proven' would carry a state-sanctioned stigma."[331] Kopp's proposal was defeated three votes to two in April of 1996.[332] But in February of 2003, another bill providing for a jury verdict of not proven was introduced by Senate President Pro Tem John Burton.[333] On May 6, 2003, in a three to one vote, the bill failed passage from the Senate Public Safety Committee, "but was granted a chance to be reconsidered at a later date."[334]

Late in 2002, the Third Circuit Court of Appeals provided some insight into how the not proven verdict clashes with American principles of collateral estoppel and jury unanimity, when it denied a motion to dismiss based on the use of the not proven verdict.[335] In Merlino, the court rejected a mobster's double jeopardy argument and "ruled that reputed Philadelphia Mafia boss Joseph 'Skinny Joey' Merlino [could] be tried again . . . on a murder charge that a . . . jury last year found 'not proven'."[336]

The Circuit Judge decided that because the jury was given faulty instructions during deliberations concerning the use of not proven, it may have chosen the verdict even though it had never reached a unanimous decision on

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328. *Senator Calls for Allowing Jury Verdicts of Not Proven*, METRO. NEWS ENTER. (Los Angeles), Jan. 22, 1996, at 11.

329. *Id.*

330. Pamela Martineau, *Senate Panel Approves Measure Aimed at Limiting Reach of Three-Strikes Law to Serious Felonies*, METRO. NEWS ENTER. (Los Angeles), Apr. 24, 1996, at 11.

331. *Kopp Trying to Tinker With A Proven Success*, METRO. NEWS ENTER. (Los Angeles), Feb. 5, 1996, at 9.

332. *Id.*

333. *End of the Month*, METRO. NEWS ENTER. (Los Angeles), Feb. 28, 2003, at 7.

334. *End of the Month*, METRO. NEWS ENTER. (Los Angeles), May 30, 2003, at 7.

335. United States v. Merlino, 310 F.3d 137, 144 (3rd Cir. 2002). "This case is the tale of two indictments, one in Pennsylvania and one in New Jersey. A multi-defendant, multi-count trial took place in the United States District Court for the Eastern District of Pennsylvania." *Id.* at 139.

336. Shannon P. Duffy, *The Skinny on Merlino's Philadelphia Conviction*, LEGAL INTELLIGENCER, Nov. 11, 2002, at 1. Merlino was acquitted of three counts of murder and two counts of attempted murder after a four-month trial, covering thirty-six indictments, where fifty witnesses were called to the stand and almost a thousand pieces of evidence were presented. *7 Reputed Mafia Figures Are Acquitted of Murder*, N.Y. TIMES, July 21, 2001, at A8. The jury still found Merlino guilty on eleven acts of racketeering. Steven P. Bann, *United States v. Merlino*, N. J. L. J., Nov. 18, 2002. The debate concerning double jeopardy arose when the government soon after indicted Merlino a second time on different racketeering provisions, but included the charge of conspiring to commit the murder brought in the first trial. *Id.*

the charge that Merlino participated in the shooting of a Mafia captain.[337] Merlino's attorney argued that "collateral estoppel principles required dismissal" of the second indictment because the jury "had entered a valid and final judgment, effectively acquitting" Merlino of the slaying.[338] But the burden was on Merlino, who failed because he could not prove the jury unanimously acquitted him.[339] Thus, the issue of his participation in the murder was not precluded.[340]

But the spirited dissent suggested that the majority should have "tossed out the New Jersey indictment on double jeopardy grounds."[341] "I submit," Judge Nygaard said, "that looking behind jury verdicts to reconstruct the jury's thinking, or attempting to determine how it may have reached consensus, is pure speculation and contravenes our fundamental constitutional heritage of treating jury verdicts as unimpeachable."[342] Instead, his contention was that not proven verdicts "should be treated as acquittals for collateral estoppel purposes."[343] Otherwise, the defendant could be "forced to prove his innocence of that charge repeatedly," which defeats "the purpose of the Double Jeopardy Clause and collateral estoppel[,] to protect defendants from having to face serial trials for the same offense."[344]

Setting aside the issues of collateral estoppel and jury unanimity, *Merlino* at least establishes an international context for the assertion that giving instructions on the use of the not proven verdict can be "highly dangerous" and

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337. Duffy, *supra* note 336. The judge said that the faulty instruction:

> makes the jury's vote ambiguous because we cannot tell from the face of the verdict sheet whether the vote was unanimously "Not Proven" or whether the jury unanimously decided that they were unable to reach a unanimous decision as to "Proven" or "Not Proven,'" . . . whether they were "hung'" on that issue.

Id.

338. *Id.*

339. Bann, *supra* note 336.

340. *Id.* The court held:

> [D]espite the notations on the special verdict sheet, Merlino cannot prove that the jury unanimously, or even by a majority, acquitted him of participation in Sodano's murder, and thus he cannot foreclose litigation of that issue. On the special verdict sheet, the Pennsylvania jury checked "Not Proven" boxes corresponding to the Sodano murder. Because, however, of the supplemental instructions given by the District Court, those check marks are ambiguous. They do not demonstrate that the jury unanimously found that the Sodano murder was "Not Proven."

Merlino, 310 F.3d at 142.

341. Duffy, *supra* note 336.

342. *Merlino*, 310 F.3d at 144 (Nygaard, J. dissenting). "[W]e do not know how the jury voted after the judge issued the second supplemental instruction, and we should not pretend that we do. We only know that it decided that this predicate act [murder] was not proven." *Id.*

343. *Id.* "Here, however, the jury was not 'hung.' It returned a verdict. We have a final judgment. The jury's decision on the murder-based predicate acts was the functional equivalent of a verdict on the stand-alone murder charge." *Id.* at 144-45.

344. *Id.*

likely to result in an appeal.[345] When taken in conjunction with the larger arguments against the not proven verdict voiced by Americans when the topic has briefly arisen, one has to wonder if implementation of a three-verdict system would improve of the delivery of justice in any particular state, or in the United States at large.

IV. FLOWER OF SCOTLAND

Like Scotland's distinctive national flower, the thistle, the not proven verdict is prickly and has definitely stuck. Even so, some wonder if the institution of the jury, let alone the not proven verdict, should be kept at all.[346] "[T]he acid test must always be, does the system deliver justice?"[347] In terms of the not proven verdict, as with juries, the answer is not always clear—even after more than three-hundred years and two formal governmental reviews.[348] Indeed the question remains: "[I]f all that was left [of the Scottish legal tradition] were the not proven verdict and the somewhat elusive concept of corroboration to distinguish Scots law . . . would it be worth keeping?"[349]

Late in 2004, a Member of Scottish Parliament (MSP) reinvigorated the debate over the controversial verdict.[350] Michael McMahon of the Labour party proposed a bill that would do away with the option of not proven.[351] This was the first move to have the verdict abolished within the Scottish Parliament[352] since it devolved in 1998.[353] For the bill to formally go before Parliament, it must have a minimum of eighteen signatures from other MSPs.[354] McMahon apparently has wide support among those in his party, and the First Minister of the Scottish Parliament[355] "is not averse to the idea of debating the issue."[356] In an echo of its response prior to *Firm and Fair*, the Scottish Executive insisted, "This is not in our immediate priorities," but added, "We will be interested to

345. *See supra* notes 100-103, and accompanying text (discussing McDonald v. HM Advocate).

346. *See generally* Bonnington, *supra* note 140.

347. *Id.*

348. *Id.*

349. Lord Dervaird, *Afterword: Prospects for the Future*, *in* THE SCOTTISH LEGAL TRADITION 91 (new enlarged ed., Scott C. Styles, ed., 1991). Writing in 1991, Lord Dervaird states that "there have been voices prophesying or urging the end of an auld sang. The times, it is said, are against the survival of Scots law as an independent system." *Id.*

350. Stuart Nicolson, *MSP bids to scrap Scotland's historic not-proven verdict*, DAILY MAIL (London), Nov. 22, 2004, at ED SC1 O4, 2.

351. *Id.*

352. *Id.*

353. *See supra* note 2 and accompanying text.

354. Nicolson, *supra* note 350.

355. The First Minister of the Scottish Parliament is equivalent to the Prime Minister in the British Parliament.

356. Kirsty Scott, *Move to Scrap Scots Option of Not Proven Verdict: Private Member's Bill Said to Have Wide Backing*, GUARDIAN (London, Final Edition), Dec. 2, 2004, at Guardian Home Pages 10.

see what support the bill attracts."[357] McMahon plans to draft the bill early in 2005 "with a view to presenting a final version for Parliament to debate before Christmas 2005."[358]

McMahon's foundational argument is that the "present system leaves the person who was charged of the crime without exoneration, and it leaves the victim or their family feeling that no justice has been done. That is an unsatisfactory situation and must be changed."[359] He has also argued that "juries should be asked to come to a definitive conclusion."[360] "It has always been in my mind that this is something the Scottish Parliament could change."[361] Once again, positions are being taken on both sides, either supporting the difference in emphasis that not proven provides (between it and not guilty), or calling for a two-verdict system relieving jurors of the ability to "pronounce on shades of guilt."[362]

Joe Duffy, father of murdered Amanda Duffy, has again taken up the cause, and supports McMahon's efforts toward definitive conclusions from juries: "That is what anybody in court . . . [and] the family of a victim deserves: a clear cut verdict. Not 'maybe', which is what not proven is. It leaves a question mark."[363] He hopes that McMahon's bill will bring Scotland "into line with the rest of the world,"[364] and "into the 20th century, never mind the 21st."[365]

McMahon's position has taken on an element of nationalism, because he believes that the verdict "does not serve Scotland well."[366] He feels that the "Scottish judicial system is something of which the country is rightly proud, yet it contains an anomaly [the not proven verdict] which too often brings the system into disrepute."[367] He suggests that the third verdict is a legitimate concern for MSPs, because it "allows Scots law to be ridiculed by not providing adequate justice for either the victim or often for the accused . . . ."[368] But the sentiment of nationalism goes both ways, as evidenced by proponents' arguments, such as, "[w]e have an ability in our country, which no other

357. Russell Fallis, *MSP Bid to Kill Off the Third Verdict*, SUNDAY EXPRESS (Highlands Edition), Nov. 21, 2004, at NEWS 2.

358. Lindsay McGarvie, *In the Dock: MSP Bids to Axe 'Not Proven' End to Court Cases*, SUNDAY MAIL (First Edition), Nov. 21, 2004, at NEWS 13.

359. *Findlay Set to Pen Defence of Not Proven Verdict; Victims' Families Angered over Book on 'Third Verdict'*, SUNDAY HERALD, Jan. 16, 2005, at NEWS 9 [hereinafter *Findlay Set to Pen Defence of Not Proven Verdict*].

360. Nicolson, *supra* note 350.

361. McGarvie, *supra* note 358. McMahon first became aware of the not proven verdict through the murder case of Amanda Duffy, which took place in the area he now represents. *Id.*

362. *Id.* (quoting Gordon Jackson, QC).

363. Scott, *supra* note 356.

364. *MSP Moves to Scrap Not Proven Verdict*, HERALD (Glasgow), Nov. 22, 2004, at 6.

365. *Findlay Set to Pen Defence of Not Proven Verdict*, *supra* note 359.

366. Scott, *supra* note 356.

367. *MSP Moves to Scrap Not Proven Verdict*, *supra* note 364.

368. McGarvie, *supra* note 358.

country has, to give an indication that a jury are simply dissatisfied with the prosecution [sic] case."[369]

Some argue that the option to rid Scots law of the not proven verdict altogether would be purposeless.[370] The justice spokesman for the Scottish National Party, Kenny MacAskill, feels it would be wrong to rush into abolishing the current system, and stated that he is "loath to abolish it without a full consideration of what it might mean."[371] "We should think long and hard before we legislate . . ." he said.[372] It might mean quite a lot. For instance, one commentator has suggested that the eight-to-seven majority required for a verdict would be an untenable ratio if Scotland switched to a two-verdict system.[373] Instead of abolition, MacAskill suggested an alternative: "[I]f there has to be a change, it should be back to what was historically the case in Scotland, which was an option of 'proven' and 'not proven', rather than 'guilty' and 'not guilty'."[374]

The question of whether the system in place satisfactorily delivers justice transcends mere cultural history and tradition. Indeed, any benefit or detriment to these must be penultimate to the mandatory requirement that justice is provided through the Scottish legal system. This does not mean, however, that simply because the methodology—or in this case, the terminology—used is unique or different, that it should be cast aside as less effective. This is especially true with the not proven verdict, where altering what makes Scots law unique would have a rippling effect requiring change at a more systemic level, such as adjusting the number of jurors or the level of agreement among jurors to convict (i.e., simple majority as opposed to unanimous decision).[375]

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369. Scott, *supra* note 356 (quoting Derek Ogg, QC). The third verdict is viewed by some Scots as "certainly a peculiarly Scotch one, and, for this alone, some of us are attached to it." Massie, *supra* note 24.

> There is something characteristically hair-splitting about it: "We'll no' say you did it, but then we'll no' affirm ye didna either." This is not only a very Scots response, expressed otherwise as "awa' ye gae and dinna dae it again": it also expresses an admirable scepticism, so admirable indeed that it may well be the most honest verdict a jury can truly give.

Id.

370. Massie, *supra* note 24. The author concludes with an eye towards nationalism: "It's probable that the current rage for innovation, and Labour's zeal to get rid of something merely because it is long-established, will result in the end of the 'bastard verdict.' If so, something else distinctively Scottish will have disappeared, and this to no great purpose . . . ." *Id.*

371. Nicolson, *supra* note 350.

372. *Id.*

373. Scott, *supra* note 356 (quoting Derek Ogg, QC). "If you change it, you need to start changing the numbers on the jury and some people might be concerned about that." *Id.* Some people are already expressing their concern: "[I]f Mr. McMahon gets his way, Scotland will follow the English route of hung juries and retrials where the same evidence will be heard in the same glare of publicity and at huge public cost." Sam Clarke, *Three-Verdict System Makes Perfect Sense*, EVENING TIMES (Glasgow), Nov. 25, 2004, at 10.

374. Nicolson, *supra* note 350. MacAskill suggests that this approach gets "back to the logic of what a sheriff or jury is being asked to consider . . . ." *Id.*

375. *See supra* notes 371-73 and accompanying text.

Many proponents of abolishing the third verdict might welcome an overhaul of the system, and call for the additional steps required to change areas related to the not proven verdict. The costs of this approach would be significant, and there is no guarantee, once the dust has settled, that the delivery of justice would be any more satisfactory.

Considering whether substituting a two-verdict system of guilty/not guilty, like that used in the United States, would prevent dissatisfaction makes this more evident. If, for example, the Aulds or the Grahams had their cases heard in the American legal system, resulting in the same outcome (acquittal for the accused), their level of dissatisfaction would persist because the underlying cause of that dissatisfaction—what happened to their children—would remain unanswered in their minds. The same holds true for the unsatisfactory stigma apparently placed upon those acquitted by a Scottish court under a not proven verdict.[376] A similar stigma is arguably placed upon any individual subjected to the severe scrutiny of the American legal process, and then acquitted.[377] O.J. Simpson has become, of course, the exemplar.[378]

Arguing for a two-verdict system of proven/not proven instead of guilty/not guilty is essentially drawing a distinction without a difference. Even where the terminology is exchanged, the same issues of party dissatisfaction arise. Furthermore, a systemic change remains necessary in Scots law to accommodate two verdicts. However, retention of the language "not proven" would provide a secondary benefit for those seeking to preserve Scottish culture and tradition. If such a compromise were made, it could strike a balance between those wanting legal reform and those wanting to maintain Scotland's individuality. Or, as is the ever-vexing problem with the not proven verdict, such a compromise could be unsatisfactory for all.

To some extent, party dissatisfaction is inherent in a system of justice, regardless of whether it utilizes two or three verdicts. Moreover, some dissatisfaction is vital to the continued development of a socially acceptable system of justice. In this light, the passionate efforts by families such as the Aulds and the Grahams serve the crucial function of posing the pivotal question in this debate: Does our system deliver justice?[379] The current outcome will likely seem harsh towards the Aulds and the Grahams. However, without more, the costs of systemic change to Scottish criminal law do not justify the perceived benefits of ridding it of the not proven verdict, or retaining "not proven" within a two-verdict system.

Ultimately, "whether there is a future for Scots law," and more specifically the not proven verdict, "will depend mainly on the respect and affection it engenders in the people of Scotland."[380] As Lord Cooper phrases it,

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376. *See supra* notes 53, 90, 94, 172, 174, 191, 213, 224, 240, 273 and accompanying text.
377. *See supra* text accompanying note 331.
378. *See supra* text accompanying notes 319-21.
379. *See supra* text accompanying note 347.
380. Dervaird, *supra* note 349. Like Duff's view of juries, Lord Dervaird considers the

"The truth is that law is the reflection of the spirit of a people, and so long as the Scots are conscious that they are a people, they must preserve their law."[381] Thus, the "Scottish people have good cause to place supreme value upon their system of jurisprudence," and should "support every effort to preserve its unique individuality."[382]

Lord Cooper goes further to consider "Scots Law from a wider standpoint than merely local or domestic," seeing his country's legal tradition as "a thing to be prized both in Scotland and beyond its Borders."[383] His vision is much more grandiose: "Scots law as it stands gives us a picture of what will some day be the law of the civilised nations, –namely a combination between the Anglo-Saxon system and the Continental system."[384] As for the present, "[i]n respect of the intermediate position which it now occupies between the two great schools of legal thought, Scots Law is at the moment unique."[385]

Scottish legal system as "a symbol, . . . the pre-eminent symbol, of the existence of Scotland as a separate nation." *Id.* *See supra* note 156.

381. Cooper, *supra* note 7, at 88.

382. *Id.* at 89. There is tension here, however, because Lord Cooper also thinks the law should be perfected "in its future service of the common purposes of Scottish society," which could arguably include abolition of the not proven verdict. *Id.*

383. *Id.* at 87. In his view "the public of Scotland should be more conscious of [this] fact." *Id.*

384. *Id.* (quoting legal critic Professor Levy Ullmann of Paris). This vision recently came under contention when the European Court of Human Rights agreed to review the not proven verdict to decide if it breaches "natural justice." Mark Macaskill, *'Not Proven' Verdict Faces European Test*, SUNDAY TIMES (London), Jan. 16, 2005, at Scotland News 18. The family of a man stabbed to death in Glasgow in 2000 lodged an appeal with the court after review of the case was twice denied. *Id.* The family argues that the not proven verdict violates articles six and fourteen of the European Convention on Human Rights, which guarantee citizens the right to a fair trial, and the right not to be discriminated against. *Id.* In this instance, the family is arguing that the not proven verdict removes the presumption of innocence, and also allows the accused two chances of being acquitted while only one of being convicted, both of which result in an unfair trial. *Id.* Therefore, the family claims that "Scots are discriminated against because they live in the only country in the world that uses the not proven verdict." *Id.*

385. Cooper, *supra* note 7, at 87.

ATTORNEY FEE-SHIFTING IN AMERICA: COMPARING, CONTRASTING, AND COMBINING THE "AMERICAN RULE" AND "ENGLISH RULE"

David A. Root*

I. INTRODUCTION

The headline in the *New York Times* read, "You Win but You Lose," as the author lamented about the money he had to pay out in successfully defending himself in a libel suit.[1] While the amount was only $5,134.80 (small fees in comparison to many lawsuits), the fact that frivolous lawsuits could be pursued by hasty plaintiffs without the threat of having to pay a successful defendant's legal costs inflamed the author as he was bitten by the "American rule."[2] Like him, other commentators and judicial experts have clamored for the adoption of the English "loser pays" rule in many areas of the law, hoping to decrease frivolous and unreasonable litigation.[3]

However, it is not all a bed of roses on the other side of the Atlantic. In London, England, Pauline Hughes brought an action against the treating physicians following her late husband's death caused by his gall bladder surgery.[4] After an initial victory in the trial court and an award of $396,000, the appellate court overturned Mrs. Hughes' victory and, in accordance with the "loser pays" rule, ordered her to pay the successful doctors' litigation expenses.[5] These expenses totaled $144,000, on top of her own legal fees of $146,000, thus totaling $290,000 in an attempt to sort out and make right the tragic events befallen her deceased husband.[6]

Suffice it to say, there are short-comings and limitations to both the American and English systems of allocating attorneys fees.[7] However, there are

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* J.D./M.B.A. candidate, 2006, Indiana University School of Law – Indianapolis, Kelley Graduate School of Business – Indianapolis. The author wishes to thank his parents, Clyde R. and Maryanne Root, as well as his brothers, Mark and Jon Root, for all of their love, support and encouragement.

1. Steven Brill, *You Win but You Lose*, N.Y. TIMES, July 2, 1980, at A27.

2. *Id.*

3. Robert Brookins, *Mixed-Motives, Title VII, and Removing Sexism from Employment: The Reality and the Rhetoric*, 59 ALB. L. REV. 1, 51 n.250 (1995) ("Congress can substantially reduce the threat from frivolous litigation by requiring losers to pay the opponent's attorney fees.").

4. John F. Vargo, *The American Rule on Attorney Fee Allocation: The Injured Person's Access to Justice*, 42 AM. U. L. REV. 1567, 1568-69 (1993).

5. *Id.* at 1569. The physicians based their appeal solely on the merits of Mrs. Hughes' medical negligence claim, and in no way argued that Mrs. Hughes' counsel had acted in an abusive manner. *Id.*

6. *Id.*

7. Gregory E. Maggs & Michael D. Weiss, *Progress on Attorney's Fees: Expanding the*

positive sides to both frameworks as well. Specifically, the contingency fee system employed in America leaves the courtroom equally open for those who wish to pursue a legal claim.[8] On the other side of the Atlantic, positive attributes of the "loser pays" rule include fuller compensation of winning plaintiffs and deterrence of frivolous claims.[9]

This Note's goal is to suggest the fashioning of a hybrid system, combining other analyses and commentaries, aiming to extract from both systems a maximum amount of positive attributes while working to keep negative by-products at a minimum. Part II of this Note traces the development and history of both the "American rule" and "English rule" to provide a working basis from which to begin building a more efficient and equitable system. Part III discusses the positive and negative qualities of the contingency fee system employed in America; Part IV discusses the positives and negatives of the "loser pays" rule of England. Part V puts forth the new system, discussing its positive and negative attributes.

II. HISTORY OF THE "AMERICAN RULE" AND THE "ENGLISH RULE"

A. *History of the "American Rule"*

Originally, the United States adopted the "loser pays" rule from England and awarded attorneys fees to the successful party.[10] As was the case in England, attorneys fees were governed by statute in colonial America, but these statutes reflected more the legislature's goal of limiting the amount a lawyer could charge his client rather than awarding the costs to the prevailing party.[11]

"Loser Pays" Rule in Texas, 30 HOUS. L. REV. 1915, 1936 (1994) ("[T]he American Rule can encourage frivolous litigation and discourage meritorious litigation."); *see also* Thomas D. Rowe, Jr., *American Law Institute Study on Paths to a "Better Way": Litigation, Alternatives, and Accommodation*, 1989 DUKE. L.J. 824, 888 (1989). Members of the middle class are most adversely affected by the "English rule" because they do not financially fall within the range of litigants who would receive subsidized legal assistance, and therefore, potentially could lose a great deal if the litigation turned out to be unsuccessful. *Id.* Thus, often times they do not pursue meritorious claims. *Id. See also* Philip J. Havers, *Take the Money and Run: Inherent Ethical Problems of the Contingency Fee and Loser Pays Systems*, 14 NOTRE DAME J.L. ETHICS & PUB. POL'Y 621, 633 (2000) ("[T]he negative effects of the Loser Pays rule are limited to the middle and lower classes who do not qualify for legal aid.").

8. Stephan Landsman, *The History of Contingency and the Contingency of History*, 47 DEPAUL L. REV. 261, 262 (1998). A fundamental goal of the contingency fee system is "to guarantee that both rich and poor will have access to the courts and will be assured an opportunity to avail themselves of the assistance of counsel." *Id.* This seems to resound the theme of equality purported in the Declaration of Independence that "all men are created equal; that they are endowed by their Creator with certain unalienable rights; that among these are life, liberty, and the pursuit of happiness . . . ." THE DECLARATION OF INDEPENDENCE para. 2 (U.S. 1776). A simple substitute of "legal justice" for "happiness" seems to fill this bill.

9. Rowe, *supra* note 7, at 888.

10. Robin Stanley, *Buckhannon Board and Care Home, Inc. v. West Virginia Department of Health and Human Resources: To the Prevailing Party Goes the Spoils . . . and the Attorney's Fees!*, 36 AKRON L. REV. 363, 365-66 (2003).

11. *Id.* at 366; *see also* Vargo, *supra* note 4, at 1571 ("Almost all colonial legislation

In 1796, the Supreme Court ultimately set the standard in *Arcambel v. Wiseman*[12] by determining that the award of attorneys fees was not appropriate.[13] Regarding the $1,600 attorneys fees awarded as damages, the Court stated:

> We do not think that this charge ought to be allowed. The general practice of the United States is in opposition to it; and even if that practice were not strictly correct in principle, it is entitled to the respect of the court, till it is changed, or modified, by statute.[14]

Thus, the "American rule," which has stood for over 200 years, is one in which each party must bear its own costs for litigation, regardless of the outcome.[15]

While each party has had to bear its own expenses for over two centuries of American jurisprudence, as with most rules, exceptions began appearing around the turn of the twentieth century.[16] There are six general categories of exceptions to the "American rule:" 1) Contracts;[17] 2) Bad Faith;[18] 3) Common Fund;[19] 4) Substantial Benefit;[20] 5) Contempt;[21] and 6) Fee-shifting statutes.[22]

1. Contracts

Riding along with the policy of freedom to contract, parties to a contract may include attorneys fees in potential litigation as a provision of the contract.[23] A primary reason for the rise of this exception was the prevailing attitude of the laissez-faire doctrine during the nineteenth century.[24] However, courts disfavor this practice, and deem unenforceable, fee-shifting provisions found to be

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regarding attorney's fees reflect an intent to control the amount an attorney could charge the client rather than an intent to shift attorney's fees as costs to be collected by the prevailing litigant.").

12. 3 U.S. (3 Dall.) 306 (1796).

13. *Id.*

14. *Id.*

15. Neal H. Klausner, *The Dynamics of Rule 11: Preventing Frivolous Litigation by Demanding Professional Responsibility*, 61 N.Y.U. L. REV. 300, 302 (1986).

16. Stanley, *supra* note 10, at 367; *see also* John Leubsdorf, *Toward a History of the American Rule on Attorney Fee Recovery*, 47 LAW & CONTEMP. PROBS. 9, 29 (Winter 1984). "Exceptions to the rule grew in number and importance, usually grounded on the same concern for incentives and disincentives [to encourage or discourage meritorious litigation]." *Id.*

17. Vargo, *supra* note 4, at 1578-79.

18. *Id.* at 1584-87.

19. *Id.* at 1579-81.

20. *Id.* at 1581-83.

21. *Id.* at 1583-84.

22. Ruth Bader Ginsburg, *Access to Justice: The Social Responsibility of Lawyers*, 7 WASH. U. J.L. & POL'Y 1, 8 (2001).

23. Vargo, *supra* note 4, at 1578.

24. *Id.*

contrary to public policy, such as when the more powerful party to the contract drafts it into the provisions.[25]

2. Bad Faith

Awarding attorneys fees for bad faith can derive from actions occurring in the filing of the lawsuit, and for conduct by parties, or their counsel, before or after the course of the proceeding.[26] Bad faith in filing a claim may warrant the award of attorneys fees if the suit brought is found to be "unwarranted," "baseless," or "vexatious."[27] While this type of bad faith revolves around the actual bringing of the claim, the Supreme Court also provides for an award of attorneys fees based on misconduct transpiring during the course of the lawsuit.[28] Additionally, the Court has expanded the "bad faith" doctrine to provide compensation to either party when the opposing party has acted inappropriately.[29] Policy drives this exception as "it awards attorney fees against parties who litigate in bad faith, for the obvious purpose of deterring illegitimate behavior in the courtroom, and sometimes outside it."[30]

3. Common Fund

The Common Fund doctrine provides an exception to the "American rule" outside the bounds of the "loser pays" rule by dispersing the litigation costs over the range of beneficiaries not involved in the litigation, but who benefit from the fund being drawn from through court order.[31] In *Trustees v. Greenough*,[32] the Supreme Court established three reasons why the Common Fund doctrine is a valid exception to the "American rule:" 1) it would be unjust for the plaintiff to bear all the costs of the litigation when there are other beneficiaries of the same class or group; 2) nonparticipating beneficiaries would have an unfair advantage; and 3) courts of equity historically have awarded attorneys fees from court-controlled funds when the suit of one creditor would benefit other creditors in a bankruptcy proceeding, with the legal

25. *Id.* at 1579. An example of this is insurance agreements in which the insurance company makes the insured liable for attorneys fees in suits where the insurance company is successful. *Id.*

26. *Id.* at 1584.

27. *Id.*

28. Hall v. Cole, 412 U.S. 1, 15. The Court stated in dicta that "'bad faith' may be found, not only in the actions that led to the lawsuit, but also in the conduct of the litigation" and may warrant imposition of attorneys fees on such party. *Id. See also* F. D. Rich Co. v. United States *ex rel.* Industrial Lumber Co., 417 U.S. 116, 129 (1974). "We have long recognized that attorneys' fees may be awarded to a successful party when his opponent has acted in bad faith, vexatiously, wantonly, or for oppressive reasons . . . ." *Id.*

29. Vargo, *supra* note 4, at 1584.

30. Leubsdorf, *supra* note 16, at 29.

31. Vargo, *supra* note 4, at 1579.

32. 105 U.S. 527 (1882).

fees coming out of the bankrupt assets.[33]

The Common Fund doctrine is applied to many situations, including antitrust litigation, mass disaster torts, and class actions.[34] Three conditions must be met before the litigation expense will be spread over a number of parties: 1) a fund must exist; 2) a court must be able to exert control over the fund; and 3) fund beneficiaries must be identifiable so the court can shift the attorneys fees to those benefiting from the litigation.[35] This doctrine's purpose is "to compensate parties who create or preserve a common fund for the benefit of others."[36]

4. Substantial Benefit

Closely related to the Common Fund doctrine is the Substantial Benefit rule, as both force nonparties to share in the litigation expenses and disallow absent parties to be unjustly enriched at the cost of the party bringing the suit.[37] Like the Common Fund doctrine (absent the fund), the court must exert some control over an entity composed of beneficiaries in order to disperse the fee award.[38] However, the key difference between the two doctrines is that the Substantial Benefit doctrine applies to non-pecuniary benefits as well as pecuniary benefits.[39]

5. Contempt

A small exception to the "American rule" can be found in contempt proceedings.[40] In *Toledo Scale Co. v. Computing Scale Co.*,[41] the Supreme Court held that a party can collect attorneys fees for the enforcement of a contempt order when seeking to enforce a judgment through contempt proceedings.[42] To determine which fees will be awarded, and when, the court looks to the willfulness of the contempt.[43]

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33. Vargo, *supra* note 4, at 1580.
34. *Id.* at 1581.
35. *Id.*
36. *Id.* at 1579.
37. *Id.* at 1581.
38. *Id.* at 1582.
39. *Id.* at 1581. The Substantial Benefit doctrine applies first and foremost to cases not involving a fund, but may also apply in conjunction with the Common Fund doctrine if such a court controlled fund exists. *Id.* at 1581-82. However, neither doctrine imposes personal liability on beneficiaries. *Id.* at 1582.
40. *Id.* at 1583.
41. 261 U.S. 399 (1923).
42. *Id.* at 427-28; *see also* Vargo, *supra* note 4, at 1583.
43. Vargo, *supra* note 4, at 1583-84 ("As a general rule, the willfulness of the contempt is a relevant factor in determining whether fees will be awarded and the amount of such fees.").

6. Fee-Shifting Statutes

Perhaps the most meaningful exception to the "American rule" can be found in statutory shifting of attorneys fees, whereas there are more than 200 federal and close to 2,000 state statutes allowing the shifting of fees.[44] Fee-shifting statutes can be divided into four main categories: 1) civil rights suits;[45] 2) consumer protection suits;[46] 3) employment suits;[47] and 4) environmental protection suits.[48] Congress has allowed these categories of statutes because they compel a higher public purpose,[49] and therefore, successful lobbying litigants should not shoulder the cost of advancing American public policy, particularly when their victory does not result in a monetary award.[50]

Although there are a minority of statutes allowing a two-way shift (essentially the "loser pays" rule in which the losing party, whether plaintiff or defendant, must pay opponent's legal fees), most legislation employs a one-way shift whereby only a successful plaintiff can recover attorneys fees via statute.[51] Regardless of whether a court enforces one-way or two-way fee-shifting

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44. *Id.* at 1588.

45. Ginsburg, *supra* note 22, at 8; *see also* William A. Bradford, *Private Enforcement of Public Rights: The Role of Fee-Shifting Statutes in Pro Bono Lawyering*, *in* THE LAW FIRM AND THE PUBLIC GOOD 125, 136 n.21 (Robert A. Katzmann ed., 1995) (citing as an example the Fair Housing Amendments Act of 1988, 42 U.S.C. § 3613(c)(2) (2004), which states, "In a civil action under subsection (a) . . . , the court, in its discretion, may allow the prevailing party, other than the United States, a reasonable attorney's fee and costs. The United States shall be liable for such fees and costs to the same extent as a private person.").

46. Ginsburg, *supra* note 22, at 8; *see also* Bradford, *supra* note 45, at 136 n.19 (citing as an example the Equal Credit Opportunity Act, 15 U.S.C. § 1691e(d) (2004) which states, "Recovery of costs and attorney fees[.] In the case of any successful action under subsection (a), (b), or (c), the costs of the action, together with a reasonable attorney's fee as determined by the court, shall be added to any damages awarded by the court under such subsection.").

47. Ginsburg, *supra* note 22, at 8; *see, e.g.*, Fair Labor Standards Act, 29 U.S.C. § 216(b) (2004) ("The court in [an action violating section 6 or 7 of this Act] shall, in addition to any judgment awarded to the plaintiff or plaintiffs, allow a reasonable attorney's fee to be paid by the defendant, and costs to the action . . . .").

48. Ginsburg, *supra* note 22, at 8; *see also* Bradford, *supra* note 45, at 136 n.20 (citing as an example the Clean Air Act, 42 U.S.C. § 7604(d) (2004), which states, "The court, in issuing any final order in any action brought pursuant to subsection (a) of this section, may award costs of litigation (including reasonable attorney and expert witness fees) to any party, wherever the court determines such award is appropriate.").

49. Ginsburg, *supra* note 22, at 8.

50. Leubsdorf, *supra* note 16, at 30. "Such legislation goes far beyond the goal of making access to the courts easier for litigants with strong cases. It embodies a policy of social reform through litigation—especially through litigation that does not yield plaintiffs a financial award from which a contingent fee may be paid." *Id.* Furthering this policy and sustaining consistency, these statutes "grant fees to virtually all prevailing plaintiffs while denying them to virtually all prevailing defendants." *Id. But see* Carrion v. Yeshiva Univ., 535 F.2d 722 (2nd Cir. 1976) (successful defendants' litigation expenses charged to unsuccessful plaintiff who brought a civil rights action for discrimination in the workplace but presented no evidence supporting her claim).

51. Vargo, *supra* note 4, at 1590.

legislation, the fact that such legislation exists at all is a sign that the "American rule" is under criticism and erosion,[52] but it does not necessarily mean a sudden shift to the "loser pays" rule.[53]

In summary, the "American rule" began as a trans-Atlantic extension of the "loser pays" rule in England.[54] In 1796, the Supreme Court stood American jurisprudence on its own two feet, stating the award of attorneys fees to the winner was inappropriate.[55] Over the years many exceptions have appeared, most notably statutory fee-shifting; nevertheless, the "American rule" is still very much in effect today.[56]

B. History of "Loser Pays" or the "English Rule"

Although first pronounced fifty years prior to the Code of Justinian, the principle that the loser must pay the winner's legal costs provides a solid starting place because of the Code's heavy influence on modern European law.[57] "The presumption of the now-codified rule was that the loser had done a wrong by insisting on his legal position, which had been proven in court to be unjustified."[58] The "English rule" reflects this principle from a slightly different angle, that a "victory is not complete in civil litigation if it leaves substantial expenses uncovered."[59] Furthermore, the "English rule" rests on two simple premises: 1) defeat provides adequate basis for imposing legal fees on the losing party; and 2) the winner deserves to be fully compensated for all legal costs, including attorneys fees and incidental expenses.[60]

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52. *See id.* at 1588. The "American rule" of prohibiting fee-shifting is "riddled with exceptions." *Id.*

53. *See* Leubsdorf, *supra* note 16, at 32.

> [T]hough fee statutes will undoubtedly continue to be passed, there is no likelihood that the English rule of almost automatic fee recovery will be any more successful in this country in the future than it has been in the past. We will continue to evolve a system of our own in which considerations of policy and politics determine which lawsuits and lawyers will be encouraged.

Id.

54. Stanley, *supra* note 10, at 365-66.

55. Arcambel v. Wiseman, 3 U.S. 306 (1796).

56. Vargo, *supra* note 4, at 1578-84.

57. W. Kent Davis, *The International View of Attorney Fees in Civil Suits: Why is the United States the "Odd Man Out" in How it Pays its Lawyers?*, 16 ARIZ. J. INT'L & COMP. L. 361, 404 (1999). It is interesting to note that originally in Roman law there were no costs associated with a legal dispute because all disputes were handled by the priests or the government, as there were no lawyers. *Id.* Lawyers began to appear, and charge clients for their services, by the time the Byzantine Empire was formed. *Id.*

58. *Id.* This is hardly consistent with the American contingency fee system's purpose of opening the courts to everyone. *See* Landsman, *supra* note 8, at 262.

59. Davis, *supra* note 57, at 405.

60. *Id.* The basics of the "English rule" are:

> 1) The objective fact of defeat is sufficient grounds for imposing legal costs on the loser, without regard to bad faith, fault, or frivolity; and 2) The costs to be reimbursed include not only the court fees and related costs but also the attorney

In legal terms, the technical beginning of the "loser pays" rule in England traces back to the Statute of Gloucester of 1275, from which it statutorily evolved over time into the rule it is today.[61] Slowly expanding, in 1601 the rule was extended to personal actions by allowing a successful plaintiff recovery so long as his debt or damages was at least forty shillings; otherwise, the plaintiff could not recover attorneys fees greater than damages and might be awarded less.[62] In 1607, successful defendants were granted relief from attorneys fees in all suits in which the plaintiff could recover fees.[63]

No major changes in the allocation of attorneys fees occurred from the late seventeenth century until 1875, when Order 55 changed the principle upon which fees were awarded, leaving the disbursement to the discretion of the High Court as opposed to automatically following the event.[64] Costs automatically followed the event in previous statutes, but Order 55 provided that, with certain exceptions, "the costs of and incident to all proceedings in the High Court shall be in the discretion of the Court."[65] When the Rules of Court were substantially rewritten in 1883, Order 55 was greatly expanded and the provisions set out in the order are still in force today.[66]

Although Order 55 was an important piece in forming the modern day "loser pays" rule, Order 65, rule 1 is arguably the single most important provision on costs.[67] Order 65, rule 1 provides:

> Subject to the provisions of the Act and these Rules, the costs of and incident to all proceedings in the Supreme Court . . . shall be in the discretion of the court or judge; . . . [p]rovided also that, where any action, cause, matter, or issue is tried with a jury, the costs shall follow the event, unless the judge by whom such action, cause, matter, or issue is tried, or the court shall, for good cause, otherwise order.[68]

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fees and other expenses incurred by the winner.

Id.

61. Geoffrey Woodroffe, *Loser Pays and Conditional Fees—An English Solution?*, 37 WASHBURN L.J. 345, 345 (1998). The Statute of Gloucester gave plaintiffs a right to claim only certain costs in specific real property suits. *Id.* The "loser pays" rule slowly expanded to encompass all litigation and apply for both successful plaintiffs and defendants. *Id.* at 345-46.

62. Arthur L. Goodhart, *Costs*, 38 YALE L.J. 849, 852 (1929). The rule was extended further in 1623 to include actions of slander and again in 1670 to trespass and assault and battery. *Id.* at 852-53. "In 1697 full costs of suit were given to a plaintiff whenever defendant's trespass was wilful [sic] and malicious." *Id.* at 853.

63. *Id.* In 1607, the revised statute was the final step taken in compensating victorious defendants. *Id.* This was a furtherance of the statute revised in 1531, which provided that a defendant could recover costs in certain actions such as trespass, case, debt, contract, covenant, detinue and account. *Id.*

64. *Id.* at 854.

65. *Id.*

66. *Id.*

67. *Id.* at 860.

68. *Id.*

Thus, while many consider the "loser pays" rule always to be automatic, it is more accurately described as a semi-automatic rule with an invisible hand guiding the courts, since they may deny the victorious party costs for good reason.

Like the "American rule," exceptions to the "loser pays" rule have also surfaced in recent years.[69] The biggest exception is the general rule that in small claims disputes each party must bear its own costs.[70] The current rule provides a "no cost" provision when the claim does not exceed a certain sum, and each party must therefore bear its own expenses.[71] "The reason for this exceptional approach was to encourage private claimants to bring small claims without legal representation, for even if they lost, they would not have to pay the costs of the other side."[72]

There are two other noteworthy exceptions, although not as significant as the small claims exception.[73] The first involves tribunals where each party must pay its own costs.[74] The second involves suits in which one party receives Legal Aid.[75] Here, when one party is legally aided and the other is privately funded, if the latter is victorious, he will usually not receive compensation for his legal costs against the legal aid fund.[76]

In summary, the "loser pays" rule originated under the Statute of Gloucester in 1275 and continued its development via subsequent legislation.[77] The rule is not an automatic award of attorneys fees to the winner, but rather one that is in the discretion of the bench, with fee-shifting carrying a substantial prevalence.[78] As with the "American rule," exceptions to the "loser pays" rule exist, but not to the extent of keeping fee-shifting from remaining the norm.[79]

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69. Woodroofe, *supra* note 61, at 346-47.

70. *Id.* at 346. This exception was established in 1970 when "Justice Out of Reach" was published by the Consumer Council, an independent council funded by the government. *Id.* This document argued for an exception to the "loser pays" rule in respect to defective goods or services. *Id.* This procedure was introduced into the County Courts in 1977. *Id.*

71. *Id.*

72. *Id.* at 346-47. Along with encouraging small claims disputes, the Consumer Council also wanted legal representation to be banned from this new procedure. *Id.* at n.6. While the government ultimately rejected this proposal, it is evident that lawyers were discouraged from small claims litigation. *Id.* In cases concerning amounts greater than £3,000, successful plaintiffs may recover their court fee plus limited expenses, but will not recover the costs or expenses of retaining a lawyer for the proceeding. *Id.* at 347.

73. *Id.*

74. *Id.* An example of such tribunal exception would be industrial tribunals involving claims of redundancy, unfair dismissal and equal pay. *Id.*

75. *Id. See infra* part IV.A.2.

76. *Id.*

77. Goodhart, *supra* note 62, at 853.

78. *Id.* at 854.

79. Woodroofe, *supra* note 61, at 346-47.

III. THE CONTINGENCY FEE SYSTEM IN AMERICA

A. *What the Contingency Fee Means for the Client and the Lawyer*

While the lay definition of the contingency fee system holds there is no bill for services when unsuccessful in litigation, this definition, although partially accurate, does not take into account all of the transactions that comprise a contingency fee agreement.[80] When a lawyer takes a case on a contingency basis, he offers the client both his legal services as well as additional services.[81] The two main additional services the lawyer provides the client in a contingency agreement are: 1) financing; and 2) insurance.[82]

1. Financing

In typical non-contingent fee agreements, lawyers charge their clients up-front with a flat fee, or quote their hourly fee and explain that incidental expenses will also be charged.[83] Lawyers charge up-front because they are well aware of the difficulties of collecting from a client after the conclusion of a case, especially after an unfavorable outcome.[84] However, in a contingency agreement, the lawyer normally will not collect fees or incurred expenses until after the conclusion of the case.[85] Therefore, by delaying collection, "the contingency fee lawyer finances the litigation for the client while a case is pending."[86]

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80. Herbert M. Kritzer, *The Wages of Risk: The Returns of Contingency Fee Legal Practice*, 47 DEPAUL L. REV. 267, 270 (1998) ("The popular image of the contingencies involved in the contingency fee does not fully represent the way the fee works.").

81. *Id.* Under a non-contingency client/lawyer agreement, the lawyer charges an hourly fee or a flat fee, as well as expenses, both with the expectation that these sums will be collected promptly and while the case is still progressing. *Id.* However, the additional services provided by a contingency agreement revolve around time and the outcome of the case. *Id.*

82. *Id.*

83. *Id.*

84. *Id.* at n.13; *see also* Abraham S. Blumberg, *The Practice of Law as Confidence Game: Organizational Cooptation of a Profession*, 1 LAW & SOC'Y REV. 15, 27 (June 1967). From a criminal lawyer's perspective, "because there are great risks of nonpayment of the fee, due to the impecuniousness of his clients, and the fact that a man who is sentenced to jail may be a singularly unappreciative client, the criminal lawyer collects his fee in advance." *Id.* (Emphasis omitted).

85. Kritzer, *supra* note 80, at 270. "One advantage that the contingency fee lawyer has is that the actual collection of the fee is usually not a problem because the lawyer typically receives the defendant's payment on behalf of the client, and then deducts fees and expenses before disbursing funds to the client." *Id.* at n.13.

86. *Id.* at 270. While this is not the traditional definition of financing, one in which money is borrowed from a third party and paid back with interest (e.g., car buyer, car seller and bank lender), the idea is the same. However, the difference here is that only the two parties (buyer and seller) are involved in the transaction, and the lawyer is essentially loaning the cost of the litigation to the client but not charging interest *per se*.

2. *Insurance*

In addition to financing, the contingency agreement also offers clients insurance by providing protection for both expenses and time.[87] Though many states require a client to compensate his lawyer for expenses incurred, when an unsuccessful result occurs under a contingency fee agreement, the lawyer typically will not look to collect these expenses.[88] Furthermore, because a lawyer collects only after a favorable judgment in a contingency agreement, he essentially bears the opportunity cost of performing the litigation regardless of the outcome, especially if unsuccessful.[89] Opportunity costs are also present in cases where there is recovery for the client.[90]

B. The Purpose of the Contingency Fee System in the United States

As stated earlier, the major purpose of the contingency fee was to provide open access to the courts for all people, regardless of their financial station.[91] This purpose became magnified by the Industrial Revolution as the number of work-related accidents increased, but those injured could not afford legal representation.[92] Consequently, this increase in laborers' claims forced the American Bar Association to accept the contingency fee as a valid system for lawyers' compensation.[93]

However, the Industrial Revolution cannot take all of the credit, or discredit, for the surge of the contingency fee in America.[94] The contingency fee also served as an attempt by American jurisprudence to expel itself from the English ideology that litigation was evil.[95] "[T]he English typically 'lumped the contingent fee in with other champertous practices that were thought to stir

87. Kritzer, *supra* note 80, at 270.

88. *Id.*

89. *Id.* ("If the lawyer obtains no recovery for the client, the lawyer absorbs the entire opportunity cost of the time expended on the case.").

90. *Id.* at 270. In these cases, the opportunity cost is the difference between the lawyer's compensation for the successful outcome and the amount of compensation he could have earned had he spent the time working on a different case, whether a flat fee case or successful contingency case. *See id.* Thus, the contingent fee lawyer must first discern which cases will be favorable, and then estimate which ones he feels will be the most profitable. *Id.* at 271.

91. Landsman, *supra* note 8, at 262.

92. Lester Brickman, *Contingent Fees without Contingencies:* Hamlet *without the Prince of Denmark?*, 37 UCLA L. REV. 29, 37 (1989). Thus, young lawyers used the contingency fee as a way to both bolster their struggling practices and provide an affordable means for those injured to pursue their legal claims. *Id.*

93. *Id.* at 37-38. "The American Bar Association [ABA], reflecting the history of the development of the contingent fee as one of grudging acceptance, gave its reluctant approval in 1908." *Id.* Further pressuring the ABA to accept the contingency fee was the increasing judicial approval of contingency fees. *Id.* at 37.

94. Aaron C. Charrier, *Taxing Contingency Fees: Examining the Alternative Minimum Tax and Common Law Tax Principles*, 50 DRAKE L. REV. 315, 320 (2002).

95. *Id.*

up unwanted litigation and involve unscrupulous lawyers in the nefarious business of brokering lawsuits.'"[96] Contrary to the English view that litigation was evil, American jurisprudence took the view that litigation should be used to cure societal problems, thus encouraging the use of the contingency fee as a financial vehicle to alleviate these ills.[97]

In conjunction with the free access to the courts made available through the contingency fee, litigation may also be used to promote broad and far reaching social policies.[98] The Supreme Court has come to highly value the contingency fee with the belief that "[c]ontingent fees, which promote access to the legal system, are . . . an expression of national policy favoring such access."[99] Thus, the contingency fee may possibly find constitutional protection in the eyes of the Court.[100]

Furthermore, one of the major criticisms of the contingency fee system, very large awards to successful plaintiffs, is viewed by some to aid in accomplishing the goal of furthering social reform.[101] As one commentator noted, "[l]arge jury awards are often the only effective incentive for changes in the interest of public safety."[102]

C. Criticisms of the Contingency Fee System

While the contingency fee system has many positive attributes that promote fairness and justice, it shares these benefits with much criticism. This criticism comes in one of four general categories: 1) a "flood" of litigation;[103] 2) frivolous and unreasonable litigation;[104] 3) unconscionably large fees;[105] and 4) unjust financial detriment to a successful defendant.[106]

1. "Flood" of Litigation

For almost 200 years, debate has raged about whether a flood of litigation has resulted from the contingency fee system of the United States.[107] Many

96. *Id.* (quoting CHARLES W. WOLFRAM, MODERN LEGAL ETHICS 527 (1986)).

97. *See* Brickman, *supra* note 92, at 38.

98. *See id.* ("[T]he United States Supreme Court has come to view litigation as a form of political and even commercial speech, which is to be encouraged and protected rather than disfavored.").

99. *Id.*

100. *Id.* at n.37.

101. Susan Arkun, *Cures for the Malpractice System*, N.Y. TIMES, July 27, 2003, § 4, at 12.

102. *Id.*

103. Landsman, *supra* note 8, at 264.

104. Tamar Lewin, *Class Actions Pay for Some Lawyers*, N.Y. TIMES, Dec. 5, 1983, at D1.

105. *Id.* The author cites to lawsuits where class action attorneys, taking a nominal twenty to twenty-five percent of the award, have either settled for or been awarded judgments of over $40 million on more than one occasion. *Id.*

106. Maggs & Weiss, *supra* note 7, at 1936.

107. Landsman, *supra* note 8, at 264.

commentators feel the contingency fee has had little to no impact on the amount of litigation, stating this claim is empty, without evidence, and citing to other causes.[108] On the other hand, the Supreme Court has stated that contingency fee agreements have led to an increase in litigation,[109] mainly due to the contingent fee based system's primary purpose of providing a "Key to the Courthouse Door."[110]

2. *Frivolous and Unreasonable Litigation*

"Congress needs to pass legal reforms to cut down on the frivolous lawsuits that provide a drag to our economy[,]" President George W. Bush stated in a news conference from the White House Rose Garden.[111] While Bush left open the cause of the high amount of frivolous lawsuits, both commentators and courts argue that the contingency fee system is to blame and must be addressed through legislative action.[112] In some situations (e.g.,

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108. *Id.* Speaking on the history and complaint of the contingency fee:

> It is interesting to observe that 175 years ago judicial critics were using virtually the same rhetoric about contingency fees as critics use today. For many in both groups the key risk alleged to arise because of contingency is a flood of litigation. This rhetoric has had a hollow ring since the beginning of the Republic. Unmanageable "floods" of lawsuits have, upon investigation, usually proven to be a chimera.

Id.

See also Marc Galanter, *Reading the Landscape of Disputes: What We Know and Dont't* [sic] *Know (and Think We Know) About Our Allegedly Contentious and Litigious Society*, 31 UCLA L. REV. 4, 69 (1983). The author credits the increase in litigation as an "adaptive response" to the many changes that have occurred in society. *Id.* Among other things, Galanter cites increases in the power and range of machinery as a catalyst for the increasing number of injuries, as well as technological advancements leading to greater knowledge of the causation of injuries, and a greater sense of personal detachment over controls, coupled with more available means of litigating, as reasons for more frequent litigation. *Id.*

109. Deposit Guaranty Nat'l Bank of Jackson, Miss. v. Roper, 445 U.S. 326, 338 (1980).

> Plainly there has been a growth of litigation stimulated by contingent-fee agreements and an enlargement of the role this type of fee arrangement has played in vindicating the rights of individuals who otherwise might not consider it worth the candle to embark on litigation in which the optimum result might be more than consumed by the cost.

Id.

110. *See* Philip H. Corboy, *Contingency Fees: The Individual's Key to the Courthouse Door*, LITIG., Summer 1976, at 27.

111. *From the Rose Garden; In Bush's Words: 'Taking the Fight to the Enemy' in Iraq*, N.Y. TIMES, July 31, 2003, at A12.

112. Richard L. Abel, *Questioning the Counter-Majoritarian Thesis: The Case of Torts*, 49 DEPAUL L. REV. 533, 548 (1999). Arguing in the context of medical malpractice suits, Abel stated "[l]imiting contingent fees would reduce frivolous suits and unrealistic settlement demands." *Id.* Abel further concluded that the increasing frequency of medical malpractice litigation contributes to the rising cost of health care. *Id. See also* Roa v. Lodi Med. Group, Inc., 695 P.2d 164, 170-71 (Cal. 1985) (arguing the legislature imposed limits on contingency fees, for medical malpractice actions, in the hopes of reducing the amount of frivolous litigation and unreasonably high settlement amounts).

medical malpractice suits), the limiting of contingency fees will arguably pass economic benefits on to consumers.[113] In addition to medical malpractice concerns, another argument against the contingency fee cites it as an opportunity for the rich to bully the poor, and the poor to blackmail the rich.[114] In the global context, in order to decrease frivolous litigation, the contingency fee system is banned in most countries outside the United States.[115]

However, some commentators find the high frequency of frivolous litigation argument to be without merit. For example, the lawyer who takes a certain percentage of the proceeds from a victorious case will screen out those cases lacking sufficient merit to avoid the opportunity cost of wasting his time and resources.[116] Coinciding with this "screening out" argument, others argue that contingency fees actually decrease the amount of frivolous litigation by changing the lawyer's incentives.[117] Nevertheless, a number of factors erode this argument.[118] One of these eroding factors, diversification, means that "if the lawyer takes several cases on a contingent fee basis, the cost of a frivolous case that loses may be offset by the rewards from frivolous cases that prevail."[119]

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113. *See* DiFillippo v. Beck, 520 F.Supp. 1009, 1016 (D. Del. 1981).

> [I]t is rational to limit attorney's fees which may be collected in malpractice suits and not in other actions because the limitation is also related to reducing malpractice insurance costs and, consequently, medical costs. For example, the attorney's fee limitation is likely to deter attorneys from instituting frivolous suits and to encourage the settlement of such suits, thus saving litigation expenses and ultimately reducing medical costs to the consumer.

Id.

114. Ernest van den Haag, *The Politics of Law: A Progressive Critique*, 82 MICH. L. REV. 988, 988 (1984) ("[The contingency fee system] encourages litigiousness and makes it inviting for rich persons to harass poor ones and for poor persons to, in effect, blackmail corporations and the rich.").

115. Paula Batt Wilson, *Attorney Investment in Class Action Litigation: The Agent Orange Example*, 45 CASE W. RES. L. REV. 291, 297 n.35 (1994) ("Contingent fees are banned in most foreign countries to avoid frivolous litigation . . . .").

116. Chris Guthrie, *Framing Frivolous Litigation: A Psychological Theory*, 67 U. CHI. L. REV. 163, 207 (2000).

117. Teal E. Luthy, *Assigning Common Law Claims for Fraud*, 65 U. CHI. L. REV. 1001, 1011 (1998). "[Contingency agreements] may actually decrease the number of frivolous lawsuits as compared to an hourly wage system by changing the lawyer's incentives." *Id.* Comparing contingency agreements to assignments, Luthy argues that by taking into account the opportunity cost of time and other cases in a contingency fee system, coupled with the fact that compensation is not guaranteed, the risk shifts from the client to the lawyer. *Id.*

118. Guthrie, *supra* note 116, at 208. Frivolous litigation still occurs because not all lawyers have the luxury of being selective with their cases. *Id.* They diversify (have high-probability and low-probability cases) to try and maximize their benefits, but some cases do not become known to be low-probability until after the discovery process. *Id.*

119. Allison F. Aranson, *The United States Percentage Contingent Fee System: Ridicule and Reform from an International Perspective*, 27 TEX. INT'L L.J. 755, 761-62 (1992). Furthermore, "[l]awyers can subsidize baseless cases by using funds from contingent cases in which they have prevailed to front the litigation costs." *Id.* at 762.

3. Unconscionably large fees

High fee percentages in contingency agreements mainly arise from the risk of the litigation being assumed by the lawyer, due to the no-win, no-pay nature of the agreement.[120] However, "[c]ommentators have criticized the use of high contingent fee arrangements in claims resolution, as opposed to litigation, contexts because the high risk does not exist."[121] Thus, it is unethical for lawyers to collect high percentage fees in contingency agreement cases involving little to no risk of loss.[122]

As a counter to this argument, some commentators contend that the contingent fee produces results roughly equal to those of flat fee or hourly based fee schedules.[123] Proponents of this theory argue that both the amount of fees collected in a contingent agreement and on a flat fee agreement are coincidental if they approximate the fee with the time and effort spent.[124] Furthermore, neither the contingency fee nor hourly flat fee agreement account for the difficulty of representation or the quality of work performed.[125] Lastly, "[a]t the very least, the contingent fee reflects the most important element of the value of legal services, which the hourly fee ignores: the result obtained."[126]

4. Unjust Financial Detriment to a Successful Defendant

A fundamental concern with the "American rule" is that defendants must pay legal fees, which may amount to huge sums, even where their actions or

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120. *See* Georgene M. Vairo, *The Dalkon Shield Claimants Trust: Paradigm Lost (or Found)?*, 61 FORDHAM L. REV. 617, 619 n.10 (1992). ("The contingent fee arrangement is supposed to shift risks from the client to the attorney—the high risk of litigating justifies a high fee.").

121. *Id.*

122. *Id.* ("Charging high contingent fees but not assuming any risk is arguably unethical."); *see also* Lester Brickman, *The Asbestos Litigation Crises: Is There a Need for an Administrative Alternative?*, 13 CARDOZO L. REV. 1819, 1837 (1992) ("By charging contingent fees, lawyers are including a risk premium[,] . . . the greater the risk, the greater the premium. Charging a premium for risk but not assuming any risk is not simply charging a grossly exorbitant fee; it is illegal and unethical as well.").

123. Elihu Inselbuch, *Contingent Fees and Tort Reform: A Reassessment and Reality Check*, 64 LAW & CONTEMP. PROBS. 175, 186-87 (Spring/Summer 2001).

124. *Id.* at 187.

> While the contingent-fee contract might produce disparities in an individual case between the number of hours of work performed and the amount paid, such disparities are not unique to contingent-fee compensation. A flat fee will accurately reflect the amount of work actually required in a particular case only by pure happenstance.

Id.

125. *Id.* (arguing highly experienced attorneys charge high hourly rates not because of their knowledge of the instant dispute, but because of the presumption that, on average, over time they will provide greater knowledge and experience on specific issues).

126. *Id.* ("One does not pay the cobbler who fails to nail the new heel to the shoe, no matter how many hours were devoted to the failure.").

behaviors are legally justified.[127] "[T]he American rule has the effect of requiring [defendants] to subsidize the depredations of contestants."[128] Thus, because the defendant must bear some of the cost for a plaintiff's unreasonable or unmerited claim, it allows plaintiffs to further pursue more unwarranted claims, with a portion of the price tag (often very expensive) unjustly going to the successful defendant.[129] This Note's opening story illustrates this concern. Although Steven Brill lost only $5,134.80 in his successful defense of a libel suit,[130] this was an expensive price to pay for a victory on summary judgment based on the running of the statute of limitations.[131]

D. What to Take from the Contingency Fee System

The most important aspect of the contingency fee system is its ability to provide all American citizens an opportunity to have their day in court.[132] To some commentators, this access to the courts is so important that they believe it should be constitutionally protected.[133] Indeed, the Supreme Court may even support this position, stating, it "is part of our 'deep-rooted historic tradition that everyone should have his own day in court.'"[134] The underlying philosophical reason driving this goal is simply, fairness—which should be a fundamental aspiration in a country founded on equality.[135]

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127. Maggs & Weiss, *supra* note 7, at 1936. The "American rule" forces "defendants to pay huge sums of money even though they have done nothing wrong." *Id.*

128. John H. Langbein, *Living Probate: The Conservatorship Model*, 77 MICH. L. REV. 63, 65 (1978). The term"defendants" has been substituted in the above text for the original "decedents' estate" in an attempt to compare the idea that the estate is frivolously being sued by a creditor of the decedent, *Id.*, with the general criticism that the "American rule" unjustly penalizes wrongly accused defendants. Maggs & Weiss, *supra* note 7, at 1936.

129. Maggs & Weiss, *supra* note 7, at 1936; *see also* Langbein, *supra* note 128, at 65 (In the living probate context, "the American rule diminishes the magnitude of a contestant's potential loss, which diminishes his disincentive to litigate an improbable claim.").

130. Brill, *supra* note 1.

131. Sheeran v. Brill, No. 80-4574, 1981 U.S. Dist. LEXIS 18410, at **4-5 (E.D. Pa. Apr. 28, 1981).

132. Landsman, *supra* note 8, at 262; *see also* Kevin Michael Kordziel, *Rule 82 Revisited: Attorney Fee Shifting in Alaska*, 10 ALASKA L. REV. 429, 454 (1993) ("Litigation outcomes are often unpredictable, and the right to have one's day in court is a central concern of the American legal system.").

133. Paul D. Carrington & Derek P. Apanovitch, *The Constitutional Limits of Judicial Rulemaking: The Illegitimacy of Mass Tort Settlements Negotiated Under Federal Rule 23*, 39 ARIZ. L. REV. 461, 472 (1997) ("The right to individual control and management of one's own personal injury claim is itself a substantive right, indeed perhaps a constitutional right.").

134. Martin v. Wilks, 490 U.S. 755, 762 (1989) (quoting 18 C. WRIGHT, A. MILLER, & E. COOPER, FEDERAL PRACTICE AND PROCEDURE § 4449, at 417 (1981)).

135. *The Paths of Civil Litigation: IV. Class Action Reform: An Assessment of Recent Judicial Decisions and Legislative Initiatives*, 113 HARV. L. REV. 1806, 1809 (2000). In citing one goal of class actions as providing the injured a legal voice, the author comments that "fair process is often celebrated as an end in itself; underlying this view is the notion that every American has a right to her 'own day in court.'" *Id.* (Internal citations omitted).

A second feature to take from the contingency fee system is the opportunity for people, or classes of people, to litigate issues of social importance.[136] The contingency fee system allows usage of litigation as a means for achieving social change in two ways: 1) pecuniary;[137] and 2) non-pecuniary.[138]

An example of pecuniary policy adjudication can be seen in the infamous McDonald's coffee case.[139] Here, the court originally awarded the plaintiff over $2.5 million after spilling scalding hot coffee on herself and receiving third degree burns.[140] The obvious intention of the court was to punish McDonald's, and make an example of them, for repeatedly failing to provide customer service that would ensure its products were safe.[141]

Non-pecuniary policy adjudication may be found in *Shelley v. Kraemer*,[142] in which residential restrictive covenants based on race were deemed unconstitutional.[143] In that case, the Court reasoned that any court upholding such covenants constituted state action, and therefore violated the Fourteenth Amendment.[144] The obvious need for such court action can be found in the language of the Declaration of Independence declaring all persons were created equal.[145]

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136. Brickman, *supra* note 92, at 38.

137. Arkun, *supra* note 101, at 12.

138. Shelley v. Kraemer, 334 U.S. 1 (1948). Conversely to the "English rule's" encouragement of "social" litigation, the "American rule" can also work to promote this type of litigation because more claims can be brought without the fear of having to pay a successful defendant's costs. *See* Herbert M. Kritzer, *Fee Arrangements and Fee Shifting: Lessons From the Experience in Ontario*, 47 LAW & CONTEMP. PROBS., 125, 133 (Winter 1984).

139. *See* Liebeck v. McDonald's Rests., No. CV-93-02419, 1995 WL 360309 (D. N.M. Aug. 18, 1994); *see also* Samuel R. Gross & Kent D. Syverud, *Don't Try: Civil Jury Verdicts in a System Geared to Settlement*, 44 UCLA L. REV. 1, 4-5 (1996). What is not so well known about this case is the history McDonald's had with serving extremely hot coffee and injuries resulting from it. *Id.* at 5. McDonald's had received over 700 complaints for serving its coffee at a dangerously high temperature. *Id.* The court, in granting such a large award, was looking to punish McDonald's for having repeatedly cold customer service by serving scalding hot coffee. *See id.* The court was also making a statement to other businesses in general, that injuries resulting from corporate stubbornness would be penalized to the utmost.

140. Gross & Syverud, *supra* note 139, at 5. The original award was $2.86 million ($160,000 in compensatory damages and $2.7 million in punitive damages), but was later reduced to $640,000. *Id.*

141. *See id.*

142. 334 U.S. 1 (1948).

143. *Id.*

144. *Id.* at 20-21.

145. THE DECLARATION OF INDEPENDENCE para. 2 (U.S. 1776). While an argument may be made that all persons, more specifically, persons of color, was not the intent of the signers of the Declaration, it is commonly held today that this phrase encompasses all persons of all colors and origins.

E. What Should Be Left Behind from the Contingency Fee System

In order to most effectively pursue the goal of an open courthouse, it is important to limit the number of frivolous or unreasonable lawsuits that clog up the system and bog down its efficiency.[146] Controls on contingent fee agreements could have the desired effect of decreasing the amount of frivolous litigation.[147] While the number of frivolous and unreasonable lawsuits needs to be decreased, it cannot be firmly stated that the contingency fee has resulted in a "flood" of litigation.[148] Nevertheless, frivolous and unreasonable litigation must ultimately be reduced in an effort to minimize the delay in hearing meritorious claims because of loaded court dockets.[149]

Unconscionably large attorneys fees in cases involving little risk of winning present another negative attribute of the contingency fee system that must be left behind.[150] It is the risk of not receiving a fee, or a fee substantially less than the lawyer's opportunity cost, that justifies the lawyer charging a risk premium.[151] Because the attorney/client relationship is a fiduciary one, it would be illegal for the attorney to charge for a service (bearing the risk) that does not exist, thus making this an obvious attribute to avoid.[152] In addition, the attorney's monetary interest in the litigation, deriving from the risk premium,

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146. Richard M. Birnholz, *The Validity and Propriety of Contingent Fee Controls*, 37 UCLA L. REV. 949, 978 (1990) (proposing contingency fee limits as a way to "decrease the amount of court overcrowding and increase judicial efficiency by deterring frivolous litigation.").

147. *Id.*

> [C]ontingency fee limits can be utilized by the legislature as a means of deterring frivolous suits [by not having a large "pie in the sky" award for the attorney]. Contingency fee limits can also be used to encourage a plaintiff to accept a lower settlement. If the attorney's percentage is smaller, a plaintiff will obtain the same net recovery from a lower overall settlement amount. An increase in the number of settlements eases the burdens on the court system by lessening the number of cases that must be tried.

Id.

See also P. DANZON & L. LILLARD, THE RESOLUTION OF MEDICAL MALPRACTICE CLAIMS: MODELING THE BARGAINING PROCESS 55-56 (1982) ("Limits on contingent fees decrease settlement size, increase the likelihood that a case is dropped, and decrease the likelihood of litigation to verdict.").

148. Landsman, *supra* note 8, at 264.

149. Birnholz, *supra* note 146, at 978.

150. Brickman, *supra* note 122, at 1837.

151. Brickman, *supra* note 92, at 70. The contingency fee system is based on an "assumption that the lawyer's risk of receiving no fee, or a fee that effectively will be well below his normal hourly rate [opportunity cost], merits compensation in and of itself; bearing the risk entitles the lawyer to a commensurate risk premium." *Id.*

152. *Id.* at 70-71 ("It is illegal because it violates the lawyer's fiduciary duty to deal fairly with clients. A lawyer who charges for a service that is not provided is at least breaching the fiduciary duty.").

has in many ways diminished the bar's reputation due to contingency fees because this risk premium appears to be solely for the attorney's benefit.[153]

IV. THE "LOSER PAYS" RULE IN ENGLAND

A. *How the "Loser Pays" Rule Applies*

"The application of the cost-shifting principle is much more complicated than the simple phrase 'loser pays' implies."[154] The traditional two-way shift most Americans think occurs is not the norm in England.[155] In England, the "loser pays" rule is not an absolute, automatic rule, but one in the court's discretion.[156] Also, the English legal system has three particular mechanisms for financing a legal claim: 1) legal expense insurance;[157] 2) legal aid;[158] and 3) trade unions (for particular parties).[159]

1. Legal Expense Insurance

Legal expense insurance (non-existent in America) is a mechanism in which the plaintiff is insured against the potential of paying the entire amount of his opponent's fees.[160] This secondary industry allows plaintiffs with strong, but not necessarily guaranteed winning cases, to enjoy access to the courts without the fear of having to fully bear a victorious opponent's costs.[161]

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153. Edward D. Re, *The Causes of Popular Dissatisfaction with the Legal Profession*, 68 ST. JOHN'S L. REV. 85, 104 (1994).

> The present concern [with the contingency fee system] stems from the fact that the lawyer's monetary stake or financial interest in the litigation appears to be antithetical to the lawyer's given objective—independent advice primarily for the benefit of the client. As a consequence, a further erosion of the public's faith in and respect for the professionalism of lawyers has occurred.

Id.

154. Herbert M. Kritzer, *Legal Fees: The English Rule*, A.B.A. J., Nov. 1992, at 54, 55.

155. *Id.* ("While most defendants, who tend to be institutional (either as named defendants or as insurers of defendants), are genuinely at risk to pay costs if they lose, this is not true for plaintiffs, especially individuals.").

156. Goodhart, *supra* note 62, at 854.

157. Havers, *supra* note 7, at 633.

158. *Id.* at 634.

159. *Id.*

160. *Id.* at 633. ("If [the plaintiff] lose[s], the litigant pays a portion of the costs, but most are picked up by the insurance carrier.").

161. *Id.* at 633-34.

> [T]his system protects individuals from the dangers of filing suits which, while meritorious, may not be guaranteed winners. Because of the inherent risk of these types of suits, under the English rule and without litigation insurance which helps minimize the risks involved if one loses, these types of cases would never be filed . . . . [W]e do not want to discourage valid claims from being brought simply because of their costs; every person deserves their day in court.

Id.

However, it is important not to confuse the functioning of legal expense insurance with complete indemnification for a plaintiff who loses on a counterclaim, as it only covers the costs of losing.[162] Also, legal expense insurance is structured so that frivolous or unreasonable claims are filtered out of the system more efficiently than in the contingency fee system because insurance providers "employ case-screening procedures that effectively remove the doubtful cases."[163]

Finally, while legal expense insurance appears greatly fortuitous, it must be noted that only about two percent of all cases litigated, circa the early 1990s, were brought by insured plaintiffs.[164] "Nonetheless, insurance makes a significant difference in how solicitors handle cases, primarily because clients need not be concerned about costs."[165]

2. Legal Aid

While only about two percent of plaintiffs utilize the legal expense insurance option, roughly twenty-eight percent of personal injury plaintiffs receive legal aid.[166] Unlike legal expense insurance, a small amount of Legal Aid is available in America; however, it is only for the severely disadvantaged and not for cases which could normally be dealt with using the contingency fee system.[167]

So what is Legal Aid? Legal aid is a program whereby financially qualified plaintiffs may have their legal costs subsidized by the government, with the norm being a full subsidy.[168] An important comparison to draw here is that over a quarter of personal injury litigants receive Legal Aid in England.[169]

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162. Kritzer, *supra* note 154, at 57. Essentially, what this means is that if a plaintiff is found to owe money to the defendant in a counter-claim, the legal insurance would not pick up the tab for this adverse judgment, but only for a portion of the costs of both parties in association with bringing the plaintiff's original claim.

163. *Id.* Since the insurance provider's biggest concern is paying out, theoretically it will be more selective and conservative in the cases it takes. *Id.* Also, because legal expense insurance only invests money, and not time, they have access to a significantly higher amount of cases to support. This in turn affords them the luxury of being more selective than a lawyer. *Id. Compare* Guthrie, *supra* note 116, at 207. In the contingency fee system there is a screening-out process in theory. *Id.* However, since the contingent lawyer's biggest concern is not paying out, but the pay out, he is more likely to be adventurous and liberal in the cases he takes on as he views himself as a "portfolio manager" of high-risk and low-risk cases. *Id.* at 208. Furthermore, not all contingent lawyers have the luxury of being completely objective in their selection because of the nature of the market. *Id.*

164. Kritzer, *supra* note 154, at 56.

165. *Id.*

166. *Id.*

167. Havers, *supra* note 7, at 634.

168. Kritzer, *supra* note 153, at 55-56. "[P]ersons whose incomes and assets fall within the appropriate guidelines are eligible to have their legal costs paid by Legal Aid, a program funded by the government . . . ." *Id.* at 55. The author goes on to say that some Legal Aid participants are required to cover a portion of their costs, but most pay little to nothing. *Id.* at 55-56.

169. *Id.* at 56.

However, in America, only those falling below the poverty line qualify for the program.[170] Nevertheless, Legal Aid augments the goal of legal expense insurance in a limited way, as its purpose is to allow injured plaintiffs who are financially disadvantaged the opportunity to seek justice without the fear of paying their opponent's legal fees if they lose.[171]

With this limited scope of purpose, some commentators feel Legal Aid is not effective and litigation should be financed from the private sector, not by the government.[172] Even some members of the English bench find Legal Aid to be severely inhibited in its effect on English justice; as one judge stated, "'Everyone knows, every lawyer particularly knows, that for the ordinary citizen unqualified for Legal Aid a lawsuit is quite out of the question.'"[173] Thus, Legal Aid opens the door to litigation for only a special class of persons.[174]

3. Trade Unions

The third mechanism employed in English litigation to alleviate the dangers of the loser paying is litigation financed through trade unions, which is utilized by almost thirty percent of accident plaintiffs (in contrast, American trade unions only get involved if the injury is work related).[175] "'Generally, unions provide both legal representation for their members and absorb litigation costs.'"[176] Additionally, unions generally secure talented and capable representation because these lawyers do not worry about their client's ability to pay since the expenses and costs are covered by the more deep-pocketed unions.[177] Like legal expense insurance and Legal Aid, the purpose of trade union financing is to help plaintiffs avoid the risks created by the "English rule," which, combined with legal expense insurance and Legal Aid, helps more than half of plaintiffs in personal injury cases avoid such risks.[178]

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170. Havers, *supra* note 7, at 634.

171. Kritzer, *supra* note 154, at 55-56.

172. Christopher Hodges, *Multi-Party Actions: A European Approach*, 11 DUKE J. COMP. & INT'L L. 321, 325-26 (2001). "[It is] the clear experience of the United Kingdom and Sweden that legal aid does not work well and that legal services should be privately financed." *Id.* The author goes on to say that private legal expense insurance should be emphasized and favored over state funded litigation. *Id.*

173. Kritzer, *supra* note 154, at 55 (quoting English judge Patrick Devlin).

174. *Id.*

175. Havers, *supra* note 7, at 634 ("[A]bout twenty-nine percent of English plaintiffs in accident cases, including nonwork-related claims, receive legal financial assistance from their trade unions.").

176. *Id.* (quoting Herbert M. Kritzer, *Legal Fees: The English Rule*, A.B.A. J., Nov. 1992, at 56).

177. Kritzer, *supra* note 154, at 56 ("Solicitors retained by the unions are generally regarded as extremely effective, in no small part because they do not have to worry about skittish clients who fear paying out substantial sums if their cases are unsuccessful.").

178. *Id.* at 55-56. "[I]n court actions involving personal injury, only about [forty] percent of English plaintiffs are subject to the downside risk of the English rule . . . ." *Id.* at 55.

> As a result of these mechanisms in England, the Loser Pays system allows the average individual to bring valid claims, while incurring only *some* of the risk of a suit (through insurance premiums, having to pay a percentage of the legal costs based on a scale of their earnings). As America has no such mitigating programs, the burden of losing falls squarely on the shoulders of the average individual, thereby making it virtually impossible, economically speaking, to file a case.[179]

B. Positive Impacts of the "Loser Pays" Rule

By having the losing party bear the costs of litigation for both parties, the "English rule" has three primary benefits: 1) fuller compensation of winners (including unjustly accused defendants);[180] 2) deterrence of frivolous claims;[181] and 3) a possible higher frequency of settlements.[182]

1. Fuller Compensation of Winners

Stemming from the Roman perspective that the loser of a lawsuit had committed a wrong against the winner by insisting on his position, which was ultimately proven incorrect,[183] the "English rule" follows this premise to conclude that a winning party does not experience total victory if costs or expenses are left unpaid by the defeated.[184] Thus, the "English rule" works to fully compensate a victorious plaintiff, awarding damages and costs,[185] as well as to fully exonerate a victorious defendant, awarding him the costs of litigating his correct position.[186] Ultimately, the "English rule" works to ensure a

> fairer method of distributing the burden of attorney fees. . . . [A]s between the party adjudged in the right and the party adjudged in the wrong, the party adjudged in the right should

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179. Havers, *supra* note 7, at 634 (Emphasis in original).

180. Werner Pfennigstorf, *The European Experience with Attorney Fee Shifting*, 47 LAW & CONTEMP. PROBS. 37, 66-67 (Winter 1984).

181. Rowe, *supra* note 7, at 888.

182. Richard A. Posner, *An Economic Approach to Legal Procedure and Judicial Administration*, 2 J. LEGAL STUD. 399, 428-29 (1973).

183. Davis, *supra* note 57, at 404.

184. *Id.* at 405; *see also* Pfenningstorf, *supra* note 180, at 83 (stating the general rule as requiring the loser to pay the winner's expenses, with no fee-shifting as the exception).

185. A. Mitchell Polinsky & Daniel L. Rubinfeld, *Sanctioning Frivolous Suits: An Economic Analysis*, 82 GEO. L.J. 397, 422 (1993) ("[T]he English rule increases the award to a winning plaintiff—by the amount of the plaintiff's litigation costs . . . .").

186. *Id.* The author goes on to say that the "English rule" compensates a victorious defendant by "impos[ing] a penalty on a losing plaintiff—equal to the defendant's litigation costs." *Id.*

bear no fee burden and the party adjudged in the wrong should bear the entire fee burden.[187]

2. Deterrence of Frivolous Claims

Perhaps the greatest impact of the "English rule" has been the deterrence of frivolous litigation, allowing the courts to be more open to meritorious claims.[188] While it is important to keep in mind that England is generally less litigious than America,[189] the "English rule" deters these claims primarily because the threat of paying a victorious defendant's legal costs raises the stakes for the plaintiff, forcing him to more carefully assess his case and act more conservatively.[190] In fact, America has roughly twenty times the amount of civil lawsuits as England (figure adjusted for population difference).[191]

A simple comparison between the quantity of English civil litigation and American civil litigation does not, in and of itself, prove the "English rule" deters litigation. However, many commentators feel that adoption of the rule would decrease the number of lawsuits in America, albeit, not always justly.[192] Ironically and unjustly, the "English rule" deters many meritorious claims as

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187. Mark S. Stein, *The English Rule with Client-to-Lawyer Risk Shifting: A Speculative Appraisal*, 71 CHI.-KENT. L. REV. 603, 604 (1995); *see also* Pfennigstorf, *supra* note 180, at 66-67.

> [A] claimant who is forced to resort to court action to enforce his claim againt [sic] a reluctant debtor is entitled to recover the full value of the claim and should not be expected to be satisfied with a lesser amount because of the necessity of suing. Likewise, one who successfully defends himself against an unjustified claim raised by another person should come out of the experience without financial loss.

Id.

188. *See* Rowe, *supra* note 7, at 888.

189. Maimon Schwarzchild, *Class, National Character, and the Bar Reforms in Britain: Will There Always be an England?*, 9 CONN. J. INT'L L. 185, 214 (1994) ("By force of culture and law, the English are less litigious than Americans.").

190. Polinsky & Rubinfeld, *supra* note 185, at 402.

> The English rule, under which the loser pays the winner's legal costs, tends to discourage frivolous suits because, if frivolous plaintiffs have a higher probability of losing than legitimate plaintiffs, making a losing plaintiff pay the winning defendant's legal costs imposes a higher expected cost on frivolous plaintiffs than on legitimate plaintiffs.

Id.

191. Schwarzchild, *supra* note 189, at 215. English civil courts handled roughly 400,000 civil cases in 1990 while American civil courts handled over nine million cases. *Id.* "In sheer volume of litigation, the differences between England and the United States are striking. . . . With something less than five times the population of England and Wales . . . the United States has perhaps twenty times the number of civil lawsuits." *Id.*

192. Roxanne Barton Conlin & Clarence L. King, Jr., *The "Loser Pays" Rule: Who Pays for Injustice?*, TRIAL, Oct. 1992, at 58, 60 ("No matter whether we think the English rule is intended to be an aggressive response to litigation or a mechanism for fairness, it will always deter litigation and inevitably create some injustice where it is implemented.").

well as frivolous claims, leaving justified plaintiffs without legal remedy.[193] Nevertheless, whether the injustices outweigh the purpose, the "English rule" acts as a deterrent to frivolous or unreasonable litigation.[194]

3. Increase in Settlements

The net effect of the "English rule" on settlements is a heatedly debated topic and one in which the Honorable Judge Richard Posner asserts that the rule leads to a greater settlement rate,[195] only later to discuss scenarios in which fee-shifting decreases the settlement rate.[196] Thus, one is left with the feeling that this impact is debatable.

Judge Posner's initial argument, that the "English rule" would increase settlements, takes on the following line of reasoning. The "English rule" raises the stakes for the parties involved in litigation by attaching attorney fees and costs to unsuccessful judgments.[197] Because the stakes of the proceeding are raised, "the expected value of litigation [is] less for risk-averse litigants, which will encourage settlements if risk aversion is more common than risk preference."[198] While a party's attitude toward risk is subjective, it can be assumed for further argument that more than likely, a party will be risk averse

193. Kritzer, *supra* note 138, at 133 ("The potential of having to pay the other side's costs may create a very substantial barrier to litigation, particularly for individuals and especially when the potential litigant is not 100% sure about his or her case."); *see also* Herbert M. Kritzer, *A Comparative Perspective on Settlement and Bargaining in Personal Injury Cases*, 14 LAW & SOC. INQUIRY 167, 174 n.30 (1989). An overwhelming majority of people interviewed in England would not pursue a lawsuit if the award for damages would be $10,000 and their chances for victory were only eighty percent. *Id.* The total attorneys fees in this hypothetical were $3,000 ($1,000 for plaintiff and $2,000 for defendant), of which the plaintiff faced only a twenty percent chance of being required to pay.

194. Rowe, *supra* note 7, at 888.

195. Posner, *supra* note 182, at 428-29. "With the costs of guessing wrong on the outcome [of the litigation] . . . higher, the dispersion of subjective probabilities about the true probability of prevailing should be reduced, leading . . . to a higher settlement rate." *Id.* at 428.

196. RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW § 21.11, at 588 (6th ed. 2003). Posner argues that when a plaintiff's belief in victory is greater than the defendant's belief in plaintiff's victory, the "English rule" makes litigation more likely than the "American rule." *Id.* Example: plaintiff believes his chances of winning are sixty percent and defendant believes plaintiff's chances of winning are forty percent. Each party will proceed to litigation because each one thinks he has a better than not chance of winning, and thus will have his attorney fees shifted to the losing party.

197. Richard L. Schmalbeck & Gary Myers, *A Policy Analysis of Fee-Shifting Rules Under the Internal Revenue Code*, 1986 DUKE L.J. 970, 977 (1986) ("[T]he clear effect of using the English rule . . . is to increase each party's stakes by the sum of *both* parties' litigation costs, not merely by the other party's costs.") (Emphasis in original); *see also* Posner, *supra* note 182, at 428. Stated slightly differently, the plaintiff's raised stakes are total recovery of judgment award and fees, as opposed to a net recovery of judgment award minus fees under the "American rule" in the case of victory. *Id.* In the case of defeat, the stakes are raised from having to bear only his costs, to having to bear both his own, and his successful opponent's costs as well. *Id.* For the defendant, the stakes are similar, just without the judgment award. *Id.*

198. *Id.*

as opposed to being risk preferred.[199] Thus, because a majority of litigants are risk averse, it is fair to conclude that "adding the possibility of a fee shift against individual litigants relying on their own resources might well result in a greater tendency to settle claims once pursued than exists under the American rule."[200]

In the end, while some commentators argue that increased stakes do not lead to a higher frequency of litigation,[201] as will be shown, others argue the exact opposite: that increased stakes work to increase the number of cases proceeding to trial (*See infra* Part IV, C). Thus, truly conclusive findings can only be found in practice.

C. Negative Impacts of the "Loser Pays" Rule

The two main criticisms of the "Loser Pays" rule are: 1) it deters reasonable and meritorious claims that are not clear winners due to the threat of paying defendant's costs;[202] and 2) it decreases the number of settlements based on higher stakes and positive outlooks on the case.[203]

1. Deters Reasonable and Meritorious Litigation Where the Case is not a Clear Winner

One of the biggest downfalls of the "English rule," as many commentators see it, is that while it deters frivolous litigation, it does so at the cost of preventing plaintiffs of modest financial means from bringing meritorious claims because the risk of paying a successful defendant's legal costs is simply too great.[204] The "English rule" can be financially unforgiving

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199. John P. Gould, *The Economics of Legal Conflicts*, 2 J. LEGAL STUD. 279, 292-93 (1973) (Risk preference should not increase the number of cases that go to trial since risk preferred parties should be able to find cheaper ways to gamble).

200. Thomas D Rowe, Jr., *Predicting the Effects of Attorney Fee Shifting*, 47 LAW & CONTEMP. PROBS., 139, 159 (Winter 1984).

201. Schmalbeck & Myers, *supra* note 197, at 979 ("High stakes . . . do not appear to lead to a higher probability that a given dispute will lead to litigation. . . . Because the primary effect of fee shifting is to increase the stakes, implementation of a fee-shifting rule . . . should not increase the number of litigated cases.").

202. Rowe, *supra* note 7, at 888.

203. Edward F. Sherman, *From "Loser Pays" to Modified Offer of Judgment Rules: Reconciling Incentives to Settle with Access to Justice*, 76 TEX. L. REV. 1863, 1869 (1998).

204. Thomas D. Rowe, Jr., *Indemnity or Compensation? The Contract with America, Loser-Pays Attorney Fee Shifting, and a One-Way Alternative*, 37 WASHBURN L.J. 317, 329-30 (1998). "Whatever the desirability of ex anted deterrence of weak or frivolous claims, general indemnity applies to frivolous and non-frivolous claims alike. Its deterrent effects, especially given risk aversion among many claimants, will extend quite far up the scale from frivolous into possibly meritorious claims . . . ." *Id.* at 330. This expansion into meritorious claims is an injustice of the "English rule" because it harms parties strictly on the basis of finances. *See id. See also* Gregory A. Hicks, *Statutory Damage Caps are an Incomplete Reform: A Proposal for Attorney Fee Shifting in Tort Actions*, 49 LA. L. REV. 763, 790-91 (1989) ("In the absence of institutional arrangements allowing plaintiffs of lesser means to avoid fee indemnity obligations

to an unsuccessful plaintiff even when "entirely reasonable in pursuing a claim that turned out at trial to lose. As a result, the rule may excessively discourage the pressing of plausible but not clearly winning claims. . . . This effect is especially likely to fall on middle class people . . . ."[205] Members of the middle class, who make up the greatest percentage of a population, are at the greatest risk because they do not qualify for subsidized assistance, and therefore would have to shoulder the entire burden of an unfavorable result.[206] Often, the chances of an unfavorable result are too great to justify the risk of proceeding with a solid claim that is not guaranteed on its merits.[207] Thus, some commentators fear that litigation will be deterred not on the merits (which is desired), but on the financial risks associated with bringing a claim that is not a sure-fire winner (which is not desired).[208]

This fear has been brought to fruition in England, where approximately eighty-five percent of accident victims do not file a claim for compensation, mainly due to fear of paying their opponent's legal costs if unsuccessful.[209] Critics of the "English rule" bemoan the opinion that civil justice in Britain "'is now too expensive for all but the poorest and the richest.'"[210] One commentator postulates that middle-income litigants would not even pursue strong claims if the risk of losing fell somewhere within to the relatively small range of $5,000 to $10,000 (small in terms of what legal fees could run).[211] Essentially, the "English rule" may deter middle class individuals from bringing meritorious claims because the threat of what could be lost is too much to put on the line.[212]

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in unsuccessful litigation, two-way fee shifting could deter such plaintiffs from bringing meritorious claims of uncertain outcome by exposing them to the risk of having to pay the defendant's legal fees.").

205. Rowe, *supra* note 7, at 888.

206. Christian Brooks, *Political Bluff and Bluster: Six Years Later, A Comment on the Texas Private Real Property Right Preservation Act*, 33 TEX. TECH L. REV. 59, 100-01 (2001) ("Making losing parties liable for all of the expenses of the suit creates an unreasonable level of risk for middle income claimants.").

207. Rowe, *supra* note 204, at 329 ("[T]here is serious and repeatedly expressed concern that general loser-pays fee shifting is too harsh and too much of a deterrent to the medium-strength claims of the middle class.").

208. William W. Schwarzer, *Fee-Shifting Offers of Judgment—An Approach to Reducing the Cost of Litigation*, 76 JUDICATURE 147, 148 (1992) ("The rule would deter some litigation, but it would do so more on the basis of a litigant's risk averseness than the merits of the litigant's case."); *see also* Michael Napier & Nick Armstrong, *Costs After the Event*, NEW L.J., Vol. 143, No. 6582, p. 12 (1993) ("'[L]oser pays' disincentive to litigate is based more upon the client's fear of costs than the merits of the claim.").

209. Rowe, *supra* note 204, at 330 n.53.

210. *Id.* (Internal citations omitted).

211. Kritzer, *supra* note 154, at 57 ("If the amount at stake were $10,000 or $25,000, most middle-income individuals still would be reluctant to put $5,000 to $10,000 on the line to pursue even a strong case.").

212. Charles W. Branham, III, *It Couldn't Happen Here: The English Rule—But Not in South Carolina*, 49 S.C. L. REV. 971, 980 (1998). "The middle-class plaintiff with a house, family, and savings has the most to lose from an adverse award of attorneys' fees." *Id.* "Therefore, when the potential of bearing the other party's litigation expenses outweighs the

2. Decreases Settlements

The fundamental argument that the "English rule" will decrease the settlement rate is simply stated as: each party believes their chances of winning are high, and therefore, in order to incur no legal costs, proceed to trial expecting to win and pay nothing.[213] To pose the argument in a slightly different manner, under the "American rule," if both parties are certain of victory, they will still settle in cases where the cost of victory at trial is more than the cost of settling; whereas, the "English rule" would encourage the litigants to proceed to trial in order to have a full recovery in the case of the plaintiff, or no loss in the case of the defendant.[214] Thus, one may conclude that "'the likelihood of trial under the British system will be greater than under the American system.'"[215]

A further argument that the "English rule" will decrease settlements relies on the same presumption used by some commentators arguing for an increase in settlements. This argument states that the "English rule" raises the stakes of the suit, and therefore, makes litigation more attractive to a hopeful plaintiff.[216] It also follows that when the defendant views his chances of winning with greater optimism, litigation becomes more attractive because of the same raised stakes.[217] This augments the argument that parties' willingness to offer, and expectation to take, depend on their beliefs regarding the lawsuit's outcome.[218] The outcomes break down into three possible categories; where the parties'

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potential gain of a meritorious suit, lower-middle-class plaintiffs may not sue at all." *Id.*

213. Sherman, *supra* note 203, at 1869 ("[P]arties . . . pursu[e] litigation because they are overly optimistic about their chances at trial, which causes them to discount the amount of attorneys' fees they will have to pay, and thus makes settlement less attractive.").

214. *Id.* at n.35.

> [U]nder the American rule, if the plaintiff firmly believed he or she would recover $10,000, and the defendant firmly believed there would be no recovery, but each anticipated having to spend $6,000 to take the case through trial, the parties might enter settlement discussions anyway, because even a $5,000 settlement would leave each party in better financial shape than a trial. Yet under the loser-pays rule, the argument goes, the litigants might dig in since each anticipates no net loss following a verdict.

Id. (quoting William W. Schwarzer, *Fee-Shifting Offers of Judgment—An Approach to Reducing the Cost of Litigation*, 76 JUDICATURE 147, 153 (1992)).

215. Sherman, *supra* note 203, at 1869 n.35 (quoting Steven Shavell, *Suit, Settlement, and Trial: A Theoretical Analysis Under Alternative Methods for the Allocation of Legal Costs*, 11 J. LEGAL STUD. 55, 65 (1982) (emphasis omitted)).

216. Keith N. Hylton, *Fee Shifting and Incentives to Comply with the Law*, 46 VAND. L. REV. 1069, 1079 (1993) ("[T]he British rule raises the stakes, which makes litigation more attractive to the parties when the plaintiff places a higher estimate on the likelihood of his winning than does the defendant."); *see also* Jay P. Kesan, *Carrots and Sticks to Create a Better Patent System*, 17 BERKELEY TECH. L.J. 763, 792 (2002) ("Because the British rule raises the stakes, it makes litigation more attractive to the plaintiff.").

217. Kesan, *supra* note 216, at 792 ("Litigation is more attractive to both parties when the defendant's estimate of the plaintiff's victory is less than the plaintiff's estimate of his chances of success.").

218. Philip J. Mause, *Winner Takes All: A Re-Examination of the Indemnity System*, 55 IOWA L. REV. 26, 31 (1969).

expectation of victory is: 1) greater than fifty percent: offer less, demand more; 2) less than fifty percent: offer more, demand less; or 3) fifty percent: no effect.[219] "Thus, if each party feels he has a better than even chance of success, indemnity will discourage pre-trial settlement by encouraging plaintiffs to demand more and defendants to offer less."[220] In the end, whether the "English rule" decreases the frequency of settlements seems to turn on the parties' beliefs regarding the strength of their respective case.[221]

V. THE NEW RULE ON COSTS

A. *Defining the New Rule on Costs*

The New Rule on Costs ("New Rule") is a combination of the "American rule" and "English rule," taking into account analysis from a myriad of commentators. However, the New Rule provides only a skeleton for the proposed system of allocating attorneys fees as opposed to a full flesh and blood model. The basis of the New Rule will be the contingency fee system, slightly modified, but still keeping the courts open to all individuals.[222] Whether fee-shifting will occur will depend on the stage of litigation in which the case is terminated. Because both the "American rule" and "English rule" do not have a clear, bright line effect on settlements, in the case of a settlement, each side will bear its own costs.[223]

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219. *Id.*

> [I]ndemnity would seem to encourage a party to offer less or demand more when he feels he has a better than even chance of success, discourages it when he feels his chance of success is less than even, and has no effect when he feels that the chance is even.

Id.

220. *Id. See also* James W. Hughes & Edward A. Snyder, *Litigation and Settlement Under the English and American Rules: Theory and Evidence*, 38 J.L. & ECON. 225, 231 (1995) ("[The] optimism effect associated with the English rule occurs because the settlement gap—the difference between the plaintiff's demand and the defendant's offer—shrinks under the English rule as the optimistic litigants anticipate shifting their costs to their rivals.").

221. Mause, *supra* note 218, at 32 ("The litigated case most often is one in which the parties have differing estimates of the probable chance and size of recovery. In such a case, indemnity might reinforce the parties' positions and place their estimates of a fair settlement value even further apart.").

222. Landsman, *supra* note 8, at 262. The New Rule must keep in line with American faith in a "robustly individualistic adversarial system where each side is given an opportunity to make its strongest case." *Id.*

223. Posner, *supra* note 182, at 428; *see also* Rowe, *supra* note 200, at 159 (arguing the "English rule" increases settlements). *But see* Schwarzer, *supra* note 208, at 153; *see also* Hylton, *supra* note 216, at 1079 (arguing the "English rule" decreases settlements); *see also* Mause, *supra* note 218, at 31 (arguing the "English rule" does not have an absolute impact on the settlement rate, but rather is better determined by each parties' subjective perception of risk). The impact of the New Rule on settlements will more than likely fall in Mause's determination that it depends on the subjective attitudes and risk aversion of the particular litigants. *See id.* Thus, it is safest to leave the system to the wild when it comes to settlements as it seems neither

If a proceeding is terminated or dismissed during a pre-trial stage (e.g., discovery, summary judgment, judgment on the pleadings, etc.), then the losing party must bear the opponent's costs, keeping in line with the old Roman ethic that the losing party does a wrong to the victor by insisting on his legal claim, which the court proves unjustified.[224] Using the same rationale for assessing fees on pre-trial judgments, the "loser pays" rule would also apply to cases adjudicated on directed verdicts, as they resolve issues of law and not fact since they never reach the fact-finder for decision.[225] Finally, cases proceeding to trial and decided by jury, as well as appellate decisions, will break down into two outcomes. (It must be noted, however, that both outcomes will be decided in the discretion of the court.)[226] Under the first outcome, which will be considered the default rule, both sides must bear their own costs.[227] Under the second outcome, the losing party must pay a percentage of the winner's costs, this percentage (1% - 100%) being at the discretion of the judge with possible consideration for the jury's recommendations.[228]

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rule has a greater impact on them than the other.

224. *See* Davis, *supra* note 57, at 404. It would seem appropriate to award fees to the winning party in cases dismissed before going to trial because it would most closely follow this old Roman law. Cases dismissed or ruled on summary judgment are cases where there is no genuine issue of material fact, and thus, the losing party has no legal basis to assert or defend his position. Thus, in such cases, a victorious plaintiff should not have to bear costs just because he had to sue to claim his recovery, and likewise, a victorious defendant should not have to pay for a claim against him that had no basis.

225. *See* Davis, *supra* note 57, at 404. While it takes longer and involves more costs, a case decided on a directed verdict still does not reach the jury. Thus, it is not the facts that are in dispute, but the law. Directed verdicts imply that the law was particularly strong on one side, which should be recognized by the parties' counsel. Therefore, having to pay the opponent's fees for a directed verdict will hopefully increase settlements, when the law is fairly clear, as the losing party does not have to pay his opponent in a settlement.

226. Goodhart, *supra* note 62, at 854. This is in line with Order 55, which put the wheels of the "English rule" as seen today in motion, that being the allocation of attorneys fees is left to the discretion of the bench. *Id.* Each outcome will remain subject to Federal Rule of Civil Procedure 68 (Offer of Judgment). FRCP 68 states, "If the judgment finally obtained by the offeree is not more favorable than the offer, the offeree must pay the costs incurred [both offeree's and offeror's] after the making of the offer." *Federal Rule of Civil Procedure 68.*

227. Schmalbeck & Myers, *supra* note 197, at 979 (discussing the Tax Court's hybrid system where most litigants bear their own costs, with some fee-shifting); *see also* Landsman, *supra* note 8, at 262; *see also* Rowe, *supra* note 7, at 888. This will be the default rule because it will still work to encourage an open system of justice and discourage the stifling of meritorious claims on the fear of paying the victorious opponent's legal fees.

228. Goodhart, *supra* note 62, at 860. This is consistent with Order 55 and Order 65, which leaves the awarding of attorneys fees to the discretion of the bench. *Id.* The jury may also give an opinion on an attorney fee award based on its intense involvement in the proceeding; *see also* Schmalbeck & Myers, *supra* note 197, at 979-80. In the Tax Court, only cases on the extreme fringes find fee-shifting allocations. *Id.* at 979. If the court finds the taxpayer's claim to be frivolous or unreasonable, it may penalize the taxpayer by awarding costs damages to the government. *Id.* Similarly, if the court finds the government's position to be substantially unjustified, it may award reasonable attorneys fees to the taxpayer. *Id.* at 979-80. The New Rule attempts to extend the Tax Court's procedure to allow for fee-shifting to reflect

B. Positives and Negatives of the New Rule

The most important feature of the New Rule is that it will keep the courts open for ordinary citizens to pursue meritorious claims that are not gold-star winners.[229] The flexibility of the New Rule will allow parties to initiate actions, despite the uncertainty inherent in litigation, and then decide whether or not to pursue the action based on where they are in the proceeding and the consequences of their decision.[230] In any case, the New Rule must not lose sight of the "most commonly cited purpose of the contingency fee . . . its 'function as a financing device that enables a client to assert and prosecute an otherwise unaffordable claim.'"[231]

1. Goals

In addition to open access, the two main goals of the New Rule are: 1) deter frivolous and unreasonable litigation;[232] and 2) provide fairness to prevailing plaintiffs or unjustly accused defendants.[233]

a. Deter Frivolous and Unreasonable Litigation

While access to the courts remains fundamental, another important goal of the New Rule is attempting to decrease frivolous and unreasonable litigation in order to alleviate the congestion these suits bring to court dockets.[234] This congestion, arising from an overwhelming number of both meritorious and frivolous cases, makes it difficult to hear the strongest and most meritorious cases within a reasonable amount of time.[235] "The bottom line cause of the frivolous litigation problem . . . is a cost structure that tends to make lawsuits in the United States 'easy to maintain and tolerable to lose.'"[236] This cost

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the parties' relative positions in the litigation, even if not on the extreme fringes. Thus, with fee-shifting being at the judge's discretion, parties in close cases should not fear being slammed with a large portion of the opponent's fees, if any.

229. Landsman, *supra* note 8, at 262. As was the goal of the early American legislatures, keeping the courts open to all people, rich and poor, must be the basis of American jurisprudence. *Id.*

230. Vargo, *supra* note 4, at 1634-35 ("Since litigation is at best uncertain one should not be penalized for merely defending or prosecuting a lawsuit, and that the poor might be unjustly discouraged from instituting such actions to vindicate their rights if the penalty for losing included the fees of their opponents' counsel."). The New Rule will allow such actions to be initiated and will allow parties to evaluate the strength of their claim before concern of paying their opponent's fees becomes realized.

231. Charrier, *supra* note 94, at 321 (quoting Lester Brickman, *Contingent Fees Without Contingencies:* Hamlet *Without the Prince of Denmark?*, 37 UCLA L. REV. 29, 43 (1989)).

232. Rowe, *supra* note 7, at 888.

233. Maggs & Weiss, *supra* note 7, at 1936.

234. Aranson, *supra* note 119, at 762. The contingent fee system has the effect of "clogging the legal system with litigation and resulting in costly delays for society." *Id.*

235. Klausner, *supra* note 15, at 301-02.

236. *Id.* at 302 (Internal citations omitted).

structure allows the contingency lawyer to take many cases in order to diversify his case portfolio, as some frivolous suits will result in settlements and finance the frivolous suits yielding no return.[237]

The New Rule seeks to eliminate these frivolous suits that yield no return through settlement. To show how this can be done, it must be explained how these suits make it to trial in the first place. Individuals bring frivolous suits, and lawyers accept them, based on the chance that the defendants will be pressured into settling even though the claim would clearly not prevail at trial.[238] Frivolous claims are essentially "'unmeritorious cases brought with the intention of securing settlement from the defendant since the defendant's unrecoverable lawyer fees could run higher than the amount the plaintiff will accept to settle the case.'"[239]

Thus, the New Rule's imposition of "loser pays" consequences on cases dismissed, ruled on summary judgment or directed verdict, or deemed frivolous by the judge, may significantly help alleviate this problem of brave-heart plaintiffs who pursue frivolous claims after settlement fails simply because they know they will not have to pay the winning defendant's legal fees.[240]

b. Provide Fairness to Prevailing Plaintiffs or Unjustly Accused Defendants

Providing fairness is a limited spin-off of the result the "English rule" has of full compensation to prevailing plaintiffs and exoneration of unjustly accused defendants as the New Rule will normally only provide partial fees and expenses upon the judge's determination.[241] While some may argue that, because the New Rule will only achieve this goal on a part time basis it is not worth implementing, the New Rule should behave more fairly on an overall basis than both the American and English rules, which have been thoroughly criticized for simply not being effective.[242] Forcing defendants to bear all or a

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237. Aranson, *supra* note 119, at 761-62.

238. Angela Wennihan, *Let's Put the Contingency Back in the Contingency Fee*, 49 SMU L. REV. 1639, 1658 (1996).

239. *Id.* (Internal citations omitted).

240. *See id.* at 151. The New Rule is aimed at solving the problem created by the "American rule" when a lawyer took a case, which has now weakened, but he is "unable to persuade the client—who has little to lose if not threatened with adverse fee shifting—to drop the case." *Id. See also* Aranson, *supra* note 119, at 761-62. This aim is in addition to the goal of preventing lawyers from diversifying their caseloads in order to profit off successful frivolous suits, which finance unsuccessful frivolous suits.

241. Rowe, *supra* note 7, at 888 (discussing the wanted effect of fuller compensation of victorious plaintiffs); *see also* Maggs & Weiss, *supra* note 7, at 1936 (discussing how defendants are forced to bear their own costs even when the suit brought against them was without merit). By providing fees and expenses via the judge's discretion, the New Rule seeks to apply "English rule" principles in a limited context.

242. Maggs & Weiss, *supra* note 7, at 1936. "[I]t remains true that the current fee system does not work as well as it should. Under the American rule, attorneys fees can devour judgments won by plaintiffs and can also force defendants to pay huge sums of money even

portion of the plaintiff's legal fees when their defense is deemed to be meritless and without justification, as determined by the stage at which judgment occurs or by the court, will work to fairly and fully compensate the plaintiff for a case that should never have been filed.[243] Likewise, the New Rule will work to provide the same justice to victorious and wholly justified defendants.[244] Meanwhile, the New Rule's imposition of costs should not work to deter meritorious litigation, a valid concern, because this imposition of costs will not necessarily be total indemnity, but instead will be based on the merits of each individual position.[245]

2. Concerns

There are two main concerns in the formation and adoption of the New Rule: 1) its effect on individuals' accessibility to the American courtroom;[246] and 2) the difficulties judges will encounter in determining what is, and what is not, frivolous and unreasonable litigation.[247]

a. The New Rule's Effect on the Accessibility of American Courts

Accessibility concerns, while not wholly unfounded, do not have a strong base because the undertone of the New Rule, a contingency fee orientation, is

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though they have done nothing wrong." *Id. See also* James H. Cheek III, *Attorneys Fees: Where Shall the Ultimate Burden Lie?*, VAND. L. REV. 1216, 1230 (1967).

> [T]he contingent fee has been devised to aid those who cannot afford litigation, but in many ways its results have been unsatisfactory, since the contingent fee has been a major impetus of litigation and, thus, of the court congestion which plagues our judicial system. Our system of fees, which in effect denies the basic rights to many by allowing the innocent injured party to go uncompensated, creates nothing but dissatisfaction and disrespect for the law and the legal profession.

Id.

It is important to clarify here that the phrase "innocent injured party" does not refer to an injured plaintiff, but the victorious party who only experiences limited victory because they have to pay their legal fees. *See also* M. Stuart Madden, *The Vital Common Law: It's Role in a Statutory Age*, 18 U. ARK. LITTLE ROCK L. REV. 555, 565 (1996) ("[A] loser pays protocol represents a 'fee shifting' approach which has been demonstrated repeatedly to be ineffective, inefficient, and unfair in working its purported goal."); *see also* Honorable Edward R. Becker, Moderator, Theodore Olson, et al., *Civil Justice and the Litigation Process: Do the Merits and the Search for Truth Matter Anymore?*, 41 N.Y.L. SCH. L. REV. 431, 449 (1997) ("'Loser pays' does not work because plaintiffs do not have the money to pay when they lose.").

243. *See* Davis, *supra* note 57, at 404. This is in line with the old Roman law that an unjustified party should make whole his adversary. *See id.* It also is in line with the premise that a victory is not complete when the costs of obtaining the victory are not covered. *Id.* at 405.

244. Maggs & Weiss, *supra* note 7, at 1936.

245. *See* Goodhart, *supra* note 62, at 860. The New Rule seeks to apply Order 65's imposition of costs as a discretionary decision of the judge instead of an automatic following of the event.

246. Rowe, *supra* note 204, at 329.

247. Robert G. Bone, *Modeling Frivolous Suits*, 145 U. PA. L. REV. 519, 529 (1997).

rooted in the long-standing view that accessibility to the courts is essential.[248] The New Rule's contingency fee basis works precisely to secure a "fundamental principle of our legal system—preservation of access to the courts."[249]

b. The Difficulties in Assessing which Claims are Frivolous

A more valid concern of the New Rule is the difficulties judges will encounter in determining which suits are frivolous and unreasonable and which suits are not.[250] "Numerous judges [have] found it difficult to get a fix on the meaning of 'frivolous' litigation, and the formulations range from the forgiving, to the unforgiving, to the 'middle.'"[251]

Three possible definitions for what constitutes a frivolous claim follow here. The first possibility is:

> [a] suit is frivolous (1) when a [party proceeds] knowing facts that establish complete (or virtually complete) absence of merit as an objective matter on the legal theories alleged, or (2) when a [party proceeds] without conducting a reasonable investigation which, if conducted, would place the suit in prong (1).[252]

A second possible definition is: "[i]t seems reasonable to characterize a frivolous suit as an action where both sides know that it is very unlikely that a trial outcome will favor [one of the parties]."[253] Finally, a third possible definition can be gleaned from Black's Law Dictionary: a "groundless lawsuit with little prospect of success."[254]

Ultimately, judges should be allowed to use their discretion to determine which suits are frivolous, using the standard applied to the determination of frivolous appeals, which is a case-by-case basis.[255]

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248. Landsman, *supra* note 8, at 262.

249. Jay N. Varon, *Promoting Settlements and Limiting Litigation Costs by Means of the Offer of Judgment: Some Suggestions for Using and Revising Rule 68*, 33 AM. U. L. REV. 813, 819 (1984).

250. Bone, *supra* note 247, at 529 ("Most commentators use the term 'frivolous suit' without defining it, as if the meaning were obvious to all. But the concept is quite slippery.").

251. Maureen N. Armour, *Practice Makes Perfect: Judicial Discretion and the 1993 Amendments to Rule 11*, 24 HOFSTRA L. REV. 677, n.235 (1996); *see, e.g.*, In re Kunstler, 914 F.2d 505, 516 (4th Cir. 1990) (adopting a harsh standard for imposing sanctions), *cert. denied*, 499 U.S. 969 (1991); United States v. Stringfellow, 911 F.2d 225, 226 (9th Cir. 1990) (adopting a relatively forgiving standard).

252. Bone, *supra* note 247, at 533.

253. I.P.L. P'ng, *Strategic Behavior in Suit, Settlement, and Trial*, 14 BELL J. ECON. 539, 548 (1983).

254. BLACK'S LAW DICTIONARY 668 (6th ed. 1990).

255. Alan G. Bryan, *Arkansas Rule of Appellate Procedure 11: What Should the Practitioner Expect?*, 53 ARK. L. REV. 661, 676 (2000). Author defines 'frivolous appeal' as

3. *Limitation of the New Rule*

The New Rule's main limitation is that it will have an uncertain effect on the rate of settlements and parties' temptation to proceed to trial in order to have their legal fees paid, either entirely or partially, by the losing party.[256] As has been demonstrated above, the effect of adhering to fee-shifting policies demonstrates neither a positive nor negative impact on the settlement rate.[257] This ambiguity rests in the subjective nature of parties' attitudes and outlooks toward trial, and the New Rule's impact cannot be measured in general terms regarding parties' subjective opinions about probabilities for victory or higher or lower stakes.[258] Instead, the New Rule's impact on settlements will be specific to the individual lawsuit, as it will turn on each party's assessment of the strength of their case winning at trial.[259]

VI. CONCLUSION

As with most theories and practices, both the "American rule" and the "English rule" have positive and negative attributes. It is the goal of this Note to forward a New Rule capitalizing on the positives of each rule and minimizing the negatives.

First and foremost, the New Rule must preserve the fundamental quality of American jurisprudence that justice is available to everyone via open courts. Implicit in this open court system, Americans must continue to be able to use the courts as a way of pursuing positive social reforms without having to bear the financial burden of advancing America into a better age of political and social theory.

Inherent in this primary goal of open access is the concern that possible fee-shifting could deter some parties from bringing meritorious claims or defenses. The structure of the New Rule attempts to safeguard against this deterrence by allowing parties to investigate their claims before the threat of paying the opposing party's legal fees becomes realized. Even then, the default rule provides an assurance that if the claim or defense contains merit, such a penalty is not a credible threat.

"one with no reasonable legal or factual basis." *Id.* In Arkansas, an objective standard is used on a case-by-case basis to determine whether an appeal is frivolous. *Id.*

256. Posner, *supra* note 182, at 428-29; *see also* Schmalbeck & Myers, *supra* note 197, at 980 (arguing fee-shifting increases settlements). *But see* Schwarzer, *supra* note 208, at 148; *see also* Hylton, *supra* note 216, at 1079 (arguing fee-shifting decreases settlements); Sherman, *supra* note 203, at 1869 (discussing parties discounting the costs of trial because they believe their fees will be covered by the losing party).

257. *See infra* note 223 and accompanying text; *see also* John J. Donohue III, *The Effects of Fee Shifting on the Settlement Rate: Theoretical Observations on Costs, Conflicts, and Contingency Fees*, 54 LAW & CONTEMP. PROBS. 195, 222 (Summer 1991) ("Until a better empirical foundation has been established, the existing theoretical arsenal is still too weak to resolve many of the ultimate questions of interest.").

258. Mause, *supra* note 218, at 31.

259. *Id.*

Following principles of fairness and justice, American jurisprudence should also fully compensate plaintiffs whose claims are sufficiently substantial that litigation should not have been pressed upon them. It is not fair to rob an injured party of a portion of their recovery simply because the party in the wrong held out for an unjustified trial. Likewise, it is not fair to impose a financial burden on defendants who were clearly right in their actions or behaviors. This is especially true when coming at the hands of a reckless plaintiff who takes the American judicial system out for a spin simply because it is relatively inexpensive to do so. Furthermore, making parties financially responsible for unreasonable claims and defenses will not only release wholly justified victorious parties from their financial burdens, but will also free up the courts to hear more meritorious cases, ones deserving the rigors of American justice.

The greatest concern centers around the uncertainty of how "frivolous" will be defined. While this is one unknown that remains, it is reasonable to allow the providence of the court to demonstrate its capabilities. In addition, states can enact legislation defining "frivolous" and provide standards and tests to make such determinations.

While many commentators disagree on the smaller points in the "American rule" "English rule" debate, most will agree that neither system functions efficiently or equitably by itself. Thus, the structure of the New Rule as a hybrid, while in its infancy and most simplistic form, attempts to forward a system that leaves the courtroom open, deters frivolous litigation without unjustly deterring meritorious litigation and justly compensates victorious parties based on the merits of each case. Perhaps no one rule can accomplish these goals, but it is time to get off the overcrowded paper sidelines of legal commentary and into the game of legal practice.

THE INVISIBLE BANK: REGULATING THE *HAWALA* SYSTEM IN INDIA, PAKISTAN AND THE UNITED ARAB EMIRATES

Adil Anwar Daudi[1]

INTRODUCTION

> In the labyrinthine depths of old Delhi, where the lanes are too narrow even for a rickshaw, men drink tea and chat in shabby offices. Nobody seems to be doing any work, until the phone rings. Then, numbers are furiously scribbled, followed by some busy dialing and whispered instruction. Although it's far from obvious in the innocuous setting, these men are moving money – to exporters, drug traffickers, tax evaders, corrupt politicians. And terrorists.[2]

In October 2001, nearly one month after the September 11, 2001 terrorist attacks, Time Magazine published an article entitled "A Banking System Built for Terrorism" which led with the paragraph quoted above. The "sinister picture" depicted by the Time Magazine author is of a *hawala* transaction, an ancient, and until now, virtually unregulated informal funds transfer (IFT)[3] system that has drawn severe criticism for its susceptibility to abuse by terrorists and other criminal elements. Indeed, descriptions of *hawala*, like that illustrated by the Time Magazine author, portray it to be a peculiar financial

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1. Doctor of Jurisprudence 2005 *(expected)*, Indiana University School of Law – Indianapolis. Bachelor of Arts in Political Science and Economics 2002, University of Michigan – Ann Arbor. The author would like to recognize his parents, Dr. Anwar Daudi and Rafat Daudi, for their sacrifice and commitment to helping all their children reach their highest potential.

2. Meenakshi Ganguly, *A Banking System Built for Terrorism*, TIME MAGAZINE, Oct. 5, 2001, http://www.time.com/time/world/printout/0,8816,178227,00.htm.

3. *See* MOHAMMED EL QORCHI ET AL., INTERNATIONAL MONETARY FUND, INFORMAL FUNDS TRANSFER SYSTEMS: AN ANALYSIS OF THE INFORMAL HAWALA SYSTEM 6 (2003). There are four reasons why the term IFT is used to describe *hawala* type transactions:

> First, in some jurisdictions, these systems are the dominant means by which financial transfers are conducted and therefore cannot be referred to as "alternative remittance systems." Second, in some communities, informal funds transfer service providers operate openly – with or without government recognition; thus, this system cannot be referred to as "underground." Third, the use of these mechanisms is often cross-cultural and multiethnic; thus the term "ethnic banking" is overly restrictive. Fourth, IFT better captures the sense and nature of financial transfers akin to conventional banking that are of primary interest. . . .

Id.

system that is both dangerous and beyond ordinary analysis.[4] References to the *hawala* system have become ambiguous over time and consequently invoke a combination of confusing and sometimes conflicting images.[5] The *hawala* system is often discussed in an alleged connection with money laundering, terrorist activities, or as a mysterious system for "moving money without money moving at all, and without leaving traces or records."[6] Contrary to these portrayals John F. Wilson, a senior economist with the International Monetary Fund (IMF), argues that *hawala* should be understood as an "economic phenomenon," comparable in mechanics and economic structure to most remittance alternatives, which can only be regulated by reducing the economic incentives to engage in *hawala*.[7]

The September 11 terrorist attacks against the United States shifted media attention to IFT systems like *hawala* and their alleged connection to money laundering and terrorist activities.[8] This has increased the level of concern about IFT systems' susceptibility to financial abuse from entities like the IMF, the World Bank Group (World Bank), and the Organisation for Economic Co-operation and Development (OECD).[9] Two years after the attacks, the international community is still attempting to locate and strengthen gaps and weaknesses in legal and financial systems worldwide.[10] The impetus of this global effort to regulate IFT systems, particularly *hawala*, has stemmed from measures recommended by the Financial Action Task Force on Money

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4. *Id.*

5. John F. Wilson, Hawala and Other Informal Payment Systems: An Economic Perspective, Remarks at Seminar on Current Developments in Monetary Financial Law (May 16, 2002), http://www.imf.org/external/np/leg/sem/2002/cdmfl/eng/wilson.pdf. Wilson argues that the *hawala* system should be regulated in light of the economic incentives inherent in the transaction. *Id.*

6. *Id.*

7. Wilson, *supra* note 5, at 12; *see also* International Monetary Fund, *About the IMF, at* http://www.imf.org/external/about.htm (n.d.) (last visited Mar. 24, 2005). "The IMF is an international organization of 184 member countries. Since the IMF was established its purposes have remained unchanged but its operations – which involve surveillance, financial assistance, and technical assistance -- have developed to meet the changing needs of its member countries in an evolving world economy." *Id.*

8. *See* Herbert V. Morais, *The War Against Money Laundering, Terrorism, and the Financing of Terrorism*, L. ASIA J., Dec. 2002, at 1; QORCHI ET AL., *supra* note 3, at 1.

9. Wilson, *supra* note 5, at 11; *see also* The World Bank Group, *About us, at* http://web.worldbank.org/WBSITE/EXTERNAL/EXTABOUTUS/0,,pagePK:50004410~piPK:36602~theSitePK:29708,00.html (n.d.) (last visited Mar.. 24, 2005). The World Bank Group is a member agency of the United Nations and "provides loans, policy advice, technical assistance and knowledge sharing services to low and middle income countries to reduce poverty." *Id.* Organisation for Economic Co-operation and Development, *About OECD, at* http://www.oecd.org/about/0,2337,en_2649_201185_1_1_1_1_1,00.html (n.d.) (last visited Mar. 24, 2005). "The OECD plays a prominent role in fostering good governance in the public service and in corporate activity . . . By deciphering emerging issues and identifying policies that work, it helps policy-makers adopt strategic orientations." *Id.*

10. Morais, *supra* note 8, at 1.

Laundering (FATF).[11] However, international guidelines designed to bring *hawala* under a regulatory umbrella fail to account for the reasons why *hawala* has survived for so many years and why it is likely to continue to survive despite increased regulation.

This note will detail the mechanics behind the *hawala* informal funds transfer system and evaluate its operation and potential for long-term existence against new international guidelines designed to regulate *hawala* businesses. This note will expand arguments advanced by Wilson and other IMF economists and suggest that, beyond formal financial sector reforms, the political environment in countries seeking to regulate their *hawala* markets should be given equal weight. To this end, this note will analyze and discuss the merits of three different models of domestic regulation of the *hawala* system, in India, Pakistan, and the United Arab Emirates (UAE), which have been modeled after international recommendations and are designed to police *hawala* transactions.

The discussion is broken into three parts. Part One will focus on *hawala* transactions generally. Part One summarizes the findings of a joint study conducted by the IMF and the World Bank regarding the mechanics behind a typical *hawala* transaction. This section chronicles the history of the *hawala* system by considering several characteristics of *hawala* transactions that help explain the reasons behind its development and why it continues to be an appealing transfer system today. Additionally, this section will outline IMF and World Bank studies that link the *hawala* system to both legitimate and illegitimate activities, which has caused its existence to raise concern in the international community. Part Two will outline the legislation that has emerged to check *hawala* businesses and transactions, primarily by examining the strength of international regulations sponsored by FATF. Finally, Part Three studies the merits of domestic regulatory efforts against *hawala* businesses in India, Pakistan, and the United Arab Emirates (UAE), which have been designed to regulate the *hawala* system and assess the relative success and failure of these legislative efforts.

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11. *See* The Financial Action Task Force On Money Laundering, OECD, *History of the FATF, at* http://www1.oecd.org/fatf/AboutFATF_en.htm#History (n.d.) (last visited Feb. 28, 2005). "In response to mounting concern over money laundering, the Financial Action Task Force on Money Laundering (FATF) was established by the G-7 Summit that was held in Paris in 1989. . . . The G-7 Heads of State or Government and President of the European Commission convened the Task Force from the G-7 member States, the European Commission, and eight other countries." *Id.*

PART ONE: *HAWALA*

A. Contemporary Mechanics of Hawala

The modern *hawala* system, which has not derogated from its roots, works by transferring funds outside of "or parallel to 'traditional' banking or financial channels."[12] A typical transaction can be described as follows:

> A remittance from a customer (CA) from country A, or a payment arising from some prior obligation, to another customer (CB) in country B. [Where] a *hawaladar* from country A (HA) receives funds in one currency from CA and, in return, gives CA a code for authentication purposes. He then instructs his country B correspondent (HB) to deliver an equivalent amount in the local currency to a designated beneficiary (CB), who needs to disclose the code to receive the funds. HA can be remunerated by charging a fee or through an exchange rate spread. After the remittance, HA has a liability to HB, and the settlement of their positions is made by various means, either financial or goods and services. Their positions can also be transferred to other intermediaries, who can assume and consolidate the initial positions and settle at wholesale or multilateral levels.[13]

Interpol[14] and IMF economists have identified three general principles represented in this typical *hawala* transfer that help to explain the mechanics behind the system and aid in establishing a broad definitional framework from which to draw upon. First, most *hawala* transactions involve simple trust relationships between *hawaldars* allowing transactions to cross international lines.[15] Second, the *hawala* system, at least implicitly, involves more than one currency.[16] Finally, *hawala* transactions involve settlement mechanisms through principles and intermediaries.[17]

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12. Patrick M. Jost & Harjit Singh Sandhu, *The Hawala Alternative Remittance System and Its Role in Money Laundering*, Interpol General Secretariat, *at* http://www.interpol.int/Public/FinancialCrime/MoneyLaundering/hawala/default.asp (Jan. 2000) (last visited Mar. 24, 2005).

13. MOHAMMED EL-QORCHI, INTERNATIONAL MONETARY FUND, THE HAWALA SYSTEM: HOW DOES THIS INFORMAL FUNDS TRANSFER SYSTEM WORK, AND SHOULD IT BE REGULATED? (Dec. 2002), http://www.gdrc.org/icm/hawala.html.

14. Interpol, *Vision*, *at* http://www.interpol.com/Public/Icpo/default.asp (n.d.) (last visited Feb. 27, 2005). "Interpol exists to help create a safer world. Its aim is to provide a unique range of essential services for the law enforcement community to optimi[z]e the international effort to combat crime." *Id.*

15. Wilson, *supra* note 5, at 2.

16. *Id.*

17. *Id. See also* QORCHI ET AL., *supra* note 3, at 14.

1. Trust and International Hawala Transactions

In the simple international *hawala* transaction detailed above, the first, and arguably most important, element of a *hawala* transaction is embodied: trust.[18] There are two prongs to the trust relationship in this classic *hawala* transaction that require attention. First, there is a trust relationship between the *hawaladar* in country A (HA) and his or her customer in country A (CA).[19] Second, there is trust relationship between HA and the *hawaldar* in country B (HB).[20] Note that in the transaction described above, there is no exchange of receipts between HA and CA.[21] Moreover, HA's recordkeeping is designed to account for the total money that is owed to HB instead of recording individual remittances he or she has made.[22] A violation of either of these trust relationships between *hawaladars* is described as an "economic death sentence" punished by ex-communication and "loss of honour."[23]

2. More Than One Currency

A *hawala* transaction is likely to involve two currencies with no participant in the transfer purchasing or selling any one currency on the foreign exchange market.[24] These transactions are accomplished "on a large scale and on-going basis" through a familial network or other connections among

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18. JOST & SANDHU, *supra* note 12 (recognizing the importance of a "trust" relationship in the simplest of *hawala* transactions); *see also* ROBERT E. LOONEY, CENTER FOR CONTEMPORARY CONFLICT, FOLLOWING THE TERRORIST INFORMAL MONEY TRAIL: THE HAWALA MECHANISM (Nov. 1, 2002), *at* http://www.ccc.nps.navy.mil/rsepResources/si/nov02/southAsia.asp (describing that in *hawala* transactions there is an implicit guarantee on payments because "broken trust would result in community ostracism constituting economic suicide for the *hawaladar*" and that the word "*hawala*" is used synonymously with the word "trust," usually to convey the personal connection between participants and the informal nature of the transactions); Kevin Anderson, *Hawala System Under Scrutiny*, BBC BUSINESS NEWS, Nov. 8th, 2001, *at* http://newsbbc.co.uk/1/hi/business/ 1643995.stm (describing *hawala* as a system built upon generations of trust between *hawala* brokers); Sonali Gudka, *India Cash Transfer 'Shake-Up*, BBC BUSINESS NEWS, Jan. 7th, 2002, *at* http://new.bbc.co.uk/1/hi/business/1747328.stm (stating that *Hawala* is a system based on trust where "brokers balance [their] transfers over time."); Laura King, *Paperless Money May Help Bin Laden*, Free Republic Conservative News Forum, Oct. 16, 2001, *at* http://www.freerepublic.com/focus/fr/549777/posts (explaining that reimbursement between *hawaladars* is based on a system of trust among the network of *hawala* brokers, who are often blood relatives).

19. *See* JOST & SANDHU, *supra* note 12.

20. *Id.*

21. *Id.* (indicating that a typical *hawala* transaction does not necessitate the *hawaladar* broker to give receipts to customers).

22. *Id.*

23. Sam Vaknin, *To Stop Bin Laden, Follow the Money*, THE NEW IDLER WEB PERIODICAL, *at* http://www.the-idler.com/IDLER-01/10-22.html (n.d.) (last visited Feb. 2, 2005).

24. Wilson, *supra* note 5, at 4 (indicating that the whole *hawala* transaction "likely involves two currencies, but no-one has bought or sold any foreign exchange").

hawaladars.[25] Independent studies by IMF and Interpol have identified several possible ways in which these networks can be formed that indicate the implicit foreign currency exchange process that is present in each *hawala* transaction.[26] The first possibility is that HA and HB are business partners where "for them transferring money is a part of another business in which they are engaged but still part of their normal business dealings with one another."[27] Another possibility is that HB may owe a debt to HA, and due to difficulties in moving money out of HB's home country, HB can repay his or her debt to HA by paying HA's *hawala* customers.[28] A final possibility is that HA has a surplus of currency in HB's country, and HB is helping HA to dispose of it.[29] Note that in the final two scenarios there is neither an exchange of currency nor does HB need to recover any money; HB is either repaying an existing debt to HA, or handling money that HA has entrusted to HB.[30]

3. *Settlement Procedures*

The claim that *hawala* "sends money without sending money" is deceptive.[31] These types of claims often stem from recognizing that the settlement aspects of informal *hawala* transactions are obscure.[32] Despite this acknowledgment, IMF and World Bank economists studying the *hawala* system have defined various settlement designs behind a typical *hawala* transaction that help illustrate the mechanics behind *hawala*. These settlement arrangements range from: (1) reverse transactions; to (2) bilateral settlement arrangements.[33]

The most obvious form of settlement for *hawala* accounts is "reverse *hawala*" or a "remittance and payment going in the opposite direction through the same two *hawaladars*."[34] The likelihood of account balancing through "reverse *hawala*" is small because of the "low probability that *hawala* remittances from country B to country A would pass through the same

25. *Id.* (recognizing that some network of family or connections among *hawaladars* is required to make such a system work); *see also* Vaknin, *supra* note 23 (stating that *hawaladars* are often members of the same family, village, clan or ethnic group).

26. JOST & SANDHU, *supra* note 12.

27. *Id. See also* Wilson, *supra* note 5, at 4 (discussing small scale *hawaladars* who are concentrated in shops and business like travel agencies, laundries, food stores and sometimes even money exchanges which are reported to conduct "backroom" *hawala* businesses); Looney, *supra* note 18 (describing *hawala* businesses as operating "in a range of settings – from curb side stalls in South Asia to back rooms and secret locations in Europe and North America").

28. JOST & SANDHU, *supra* note 12 (describing the various possible relationships between two individual's engaged in *hawala*).

29. *Id.*

30. *Id.*

31. QORCHI ET AL., *supra* note 3, at 14.

32. *Id.*

33. *Id.* at 15.

34. *Id.* at 14.

hawaladars."[35] Also, because aggregate remittance flows are unbalanced, with some countries acting as natural net sources of remittances and others carrying large outflows of private transfers, it would seem "mathematically difficult for a significant fraction of *hawala* activity to be 'settled' through simple or bilateral reverse transactions."[36]

The more likely debt settlement procedure is one involving bilateral financial settlement using third country accounts.[37] Under this rubric, HA can settle obligations to HB through a deposit in an account maintained by HB, which is located in a country that readily accepts convertible currency transactions.[38] In this model, no actual foreign exchange transaction has taken place between HA and HB as the underlying exchange rate is implicit in the relationship between the *hawala* remittance and the settlement account.[39]

B. Roots of the Hawala System

1. Hawala and Formal Transfer Systems

Informal funds transfer (IFT) systems have been in use in numerous regions around the world for many years.[40] The *hawala* system is a type of IFT system that exists under many names and in many countries of the world.[41] The *hawala* system is one of the earliest banking systems in history, predating even "traditional" or "western" banking.[42] *Hawala* developed in South Asia and was used primarily for trade financing.[43] The dangers of traveling with gold and

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35. *Id.*
36. *Id.*
37. *Id.* at 15.
38. *Id.*
39. *Id.*
40. EL-QORCHI, *supra* note 13. Mohammed El Qorchi a senior economist with the IMF, has chronicled the history of the *hawala* system and indicates in this article that IFT systems are used in many regions around the world for transferring funds, both domestically and internationally. *See also* JOST & SANDHU, *supra* note 12 (discussing *hawala*'s status as a major remittance system used around the world). For a discussion on other IFT systems in Asia and South America, see Morais, *supra* note 8, at 1.
41. EL-QORCHI, *supra* note 13; *see also Report on Money Laundering Typologies*, FATF, Doc. FATF-XIV 3 (Feb. 14, 2003) (describing different variations of the *hawala* system including *hundi*, *fei-chen* and the black-market peso exchange).
42. JOST & SANDHU, *supra* note 12 (discussing *hawala*'s origins in India before the introduction of western banking practices). For a discussion on early Islamic Banking and the initial development of promissory notes, assignments and transfer of debts via bills of exchange by Muslim merchants, see Vaknin, *supra* note 23.
43. JOST & SANDHU, *supra* note 12. Consider the following narrative of an early *hawala* transaction where:

> In 1424 by the Christian calendar, Rashid Ibn Umar al-Muza contemplated the dangerous journey he was about to begin. His trading caravan had met with great success (Allah be praised) and now, in Begram in the Kushan Empire, camels laden with art, furs and spices, Rashid was ready to set off. In his satchel he carries his caravan's profit as marks on a sheepskin. Rashid repatriated his

other forms of payment on routes plagued with thieves and bandits necessitated its development.[44] The term *hawala* means "transfer" or "wire" in Arabic and is distinguished from the "*hawala* system," which "refers to an informal channel for transferring funds from one location to another through service providers – known as *hawaldars* – regardless of the nature of the transaction and the countries involved."[45] The spirit of a *hawala* transfer is informality. The remittance occurs from one party to another without the use of a formal financial institution like a bank or money exchange.[46]

Media and even academic comments on informal transfer systems like *hawala* note that "[they] can be used to send money without sending money."[47] These portrayals suggest that *hawala* transfers are something different from more institutionalized means of making international payments.[48] In comparing contemporary conventional remittance channels, such as banks and exchange houses, including facilities like Western Union[49] and MoneyGram,[50] it is apparent that the mechanics of such transactions are strikingly similar to the *hawala* system.[51] Under both the *hawala* system, and formal remittance

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> earnings by *Hawala*, an ancient form of money transfer. For added safety, only Rashid knew the secret greeting that would validate his sheepskin. Rashid repatriated his earnings by *Hawala* . . . .

From Peshawar to Miami – Hawala, The Money Express, NEWPORT NEWS (Newport Financial Group S.A.), Nov. 15, 2001, at 1, http://www.newpac.com/Resources/Issue1_Nov-15-01.pdf.

44. JOST & SANDHU, *supra* note 12; *see also* Vaknin, *supra* note 23 (describing *hawala* as a system older than the West). For a discussion on *hawala* as a traditional method of moving money in South Asia in order to protect early merchants against robbery on the silk road, see BEATE REZAT, HAMBURG INSTITUTE OF INTERNATIONAL ECONOMICS, HAWALA, *at* http://www.hwwa.de/Projekte/ luD_Schwerpunkte/IDSPs/Asia_Gateway/Hawala.htm (n.d.) (last visited Feb. 2, 2005).

45. EL-QORCHI, *supra* note 13; *see also* Looney, *supra* note 18 (defining *hawala* as a transfer or remittance from one party to another); REZAT, *supra* note 44 (defining *hawala* as an "unofficial alternative remittance and money exchange system enabling the transfer of funds without their actual physical move."); Senator Evan Bayh, Prepared Statement at the Hearing Before the Subcommittee on International Trade and Finance on *Hawala* and Underground Terrorist Financing Mechanisms (Nov. 14, 2001) (on file with author) [hereinafter Congressional Hearing] (describing *hawala* to consist of "system brokers that provid[e] paperless banking transactions and enables individuals to transfer large sums of cash from one country to another without the funds ever crossing borders or being recorded."); *Report on Money Laundering Typologies*, FATF, Doc. FATF-XIV 3 (Feb. 14, 2003) (distinguishing between the Arabic term "*hawala*" and the "*hawala* information transfer system").

46. Looney, *supra* note 18. The *Hawala* system in conventional definitions is simply a transfer or remittance from one party to another, "without the use of a formal financial institution such as a bank or money exchange, and is in this sense an 'informal' transaction." Wilson, *supra* note 5, at 2.

47. *Id.* at 1.

48. *Id.*

49. MANUEL OROZCO, MULTILATERAL INVESTMENT FUND OF THE INTER-AMERICAN DEVELOPMENT BANK, WORKING PAPER ON WORKER REMITTANCES IN AN INTERNATIONAL SCOPE 6 (March 2003). Western Union has the largest worldwide presence in the money transfer industry with one-quarter of the global market. *Id.*

50. *Id.* "Companies like MoneyGram and Thomas Cook also operate globally, though with a lesser presence than Western Union." *Id.*

51. Wilson, *supra* note 5, at 5.

channels, "payments are made out of balances at the receiving end, with settlements to follow or, in cases where there are no exchange control issues, institutional accounts can be debited/credited congruently."[52] Indeed, Wilson is accurate in his suggestion that from an economic and accounting perspective there are very few dissimilar models of remittances systems around the world with the main difference being their respective relationship to institutional or informal financial channels.[53]

2. Why Hawala?

The *hawala* system's apparent likeness to more common remittance systems begs the question – why would individuals continue to use the less formal *hawala* system in lieu of more institutionalized financial remittance systems? A joint study by the IMF and World Bank, in addition to an independent examination conducted by Interpol, advance several motivations behind the modern day use of the *hawala* system, including the: (1) cost effectiveness;[54] (2) speed;[55] and (3) versatility of each transaction.[56]

One of the primary reasons behind why *hawala* competes effectively with other remittance mechanisms is due to its cost effectiveness.[57] *Hawaladars* are remunerated by charging a fee for each transaction and are often able to keep their expenses lower than payments made through the formal banking sector.[58] The lower expenses maintained by *hawaldars* can be explained by examining the infrastructure required by *hawala* dealers to carry out business activities, which is less complicated compared to that of banks involved in international payment transactions or even international money changers.[59] Indeed, *hawaladars* are capable of operating from "their homes or little shops, or can be accommodated within already existing businesses[,]" which is unique as compared to formal banks where more consideration is given to the "commercial and tax aspects of accounting principles or formal accounting procedures."[60] Additionally, *hawaladars* are able to "exploit naturally

52. *Id.*

53. *Id.*

54. JOST & SANDHU, *supra* note 12 (describing that the primary reason why anyone would bother with *hawala* is cost effectiveness); *see also* Wilson, *supra* note 5, at 3 (describing *hawala*-type transactions as sometimes benefiting from a better exchange rate and much cheaper than transfers through established, licensed financial institutions); QORCHI ET AL., *supra* note 3, at 7.

55. JOST & SANDHU, *supra* note 12; *see also* Wilson, *supra* note 5, at 3; QORCHI ET AL., *supra* note 3, at 7.

56. QORCHI ET AL., *supra* note 3, at 7.

57. JOST & SANDHU, *supra* note 12.

58. QORCHI ET AL., *supra* note 3, at 7.

59. *Id.* at 8.

60. JOST & SANDHU, *supra* note 12 (explaining that *hawala* businesses "operate out of rented storefronts as opposed to bank buildings, which have expensive vault and alarm systems, and may share space with other businesses, further reducing operational expenses").

occurring fluctuations in the demand for different currencies" allowing them to offer their customers rates that are better than those offered by banks.[61]

Furthermore, advancements in communication and technology, like fax machines and email, have "greatly benefited" the relative speed in which a *hawala* transfer can take place.[62] As such, a typical *hawala* transfer can take, on average, between six to twelve hours and no longer than one or two days, depending on the destination of the payment and the reliability of communication.[63] The speedy *hawala* system can be contrasted with more sluggish international wire transfer systems or courier services that formal financial institutions employ.[64] Indeed, unlike the informal system used by *hawaldars*, formal international wire transfer systems that involve banks can take over a week and are hampered by delays due to "holidays, weekends and time differences."[65]

Furthermore, the versatility of *hawala* transactions makes them an appealing system for remittances in nations where formal banks lack the capacity to provide international or domestic remittance services.[66] *Hawala* transactions are suited for adapting to "wars, civil unrest, conflicts and economic crisis."[67] In Afghanistan, for example, where the formal banking

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61. *See* JOST & SANDHU, supra note 12 (describing a *hawaldar* operating in the United States who is involved in legitimate remittances and could make a profit off an exchange rate margin as small as 2%, making him much more competitive than a bank); *see also* Looney, *supra* note 18 (describing that for the "blue collared worker with a monthly stipend of $100, the unofficial *hawala* system is a far cheaper way to send money back home than the official banking system" where *hawala* provides a more favorable market exchange rate than the official one).

62. QORCHI ET AL., *supra* note 3, at 7. "Payment orders can now be sent by facsimile, telephone, or email . . . [and] as the system is based on trust, modern telecommunication is not a requisite. Historically, numerous *hawala* transactions could be carried out by word of mouth, and reimbursements were based on personal notes, rather than formal documents." *Id.*

63. QORCHI ET AL., *supra* note 3, at 7. These authors note that "transfers between countries where the recipient is in a location with a different time zone or where communications are less reliable require [twenty-four] hours. Slightly more time may be required for payments in more rural regions or villages where the *hawaladar* does not have a local office or representative." *Id. See also* EL-QORCHI, *supra* note 13 (describing that in the *hawala* system "funds are often delivered door to door within 24 hours by a correspondent who has quick access to villages even in remote areas"); JOST & SANDHU, *supra* note 12.

64. *Id.* About a week is required to send "a bank draft from North America to South Asia via a courier service. Surface mail is not an option where the contents are valuable, and can it can also take several weeks to arrive." *Id.*

65. *Id.*

66. QORCHI ET AL., *supra* note 3, at 9. "The six licensed banks in Afghanistan do not provide any commercial banking services . . . unless they physically move money around the country, most organizations operating in Afghanistan use the informal financial sector to conduct banking business." *Id.*

67. *Id.* at 9. The informal *hawala* system has existed in conflict-torn regions such as Afghanistan, Iraq, Kosovo and Somalia.

> In Guinea, for example, the scarcity of foreign currency in the official market, associated with exchange controls and the expansion of the parallel market for the Guinean franc, boosted a *hawala*-type system in a parallel market in the

system is not operational, many organizations are forced to resort to IFT systems because commercial banks lack the capacity to service their needs.[68] The weakness of local currencies and the rise in the gap between official and parallel markets encourages individuals to rely on IFT systems for funds remittance.[69]

C. *Legitimate vs. Illegitimate Uses*

In the preceding discussion, no distinction was made between *hawala* transactions where the source of the money is legitimate (white *hawala*) and where the source and intent of the transactions is illegitimate (black *hawala*).[70] Both Interpol and the IMF suggest that such a distinction is important for regulating *hawala* businesses and enforcing smuggling, money laundering, and terrorist financing legislation.[71] While the legitimacy of informal *hawala* transactions are subject to national legal frameworks, "white *hawala*" transactions consist mainly of migrant worker remittances, humanitarian relief aid, and personal investments and expenditures.[72] "Black *hawala*" transactions, in contrast, are "almost always associated with a serious offense that is illegal in most jurisdictions" like smuggling, money laundering and terrorist financing.[73]

1. *Migrant Workers Remittances – White Hawala*

Global trends suggest that at "around 200 million people migrate annually."[74] International worker migration represents three percent of the global population of six billion.[75] Migration flows are likely greater than these

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> 1990's, which enabled people to transfer funds to Europe or the United States within hours. The Nigeria emigrants are reportedly using the informal system to remit funds to their home country.

Id.

68. *Id* at 9.

69. *Id.*

70. JOST & SANDHU, *supra* note 12. Under Indian and Pakistani terminology, the term "white *hawala* is used to refer to legitimate transactions." *Id.* On the other hand, "black *hawala* refers to illegitimate transactions, specifically money laundering." *Id.*

71. *Id.*

72. *Id. See also* QORCHI ET AL., *supra* note 3, at 12.

73. JOST & SANDHU, *supra* note 12; *see also* QORCHI ET AL., *supra* note 3, at 12. This joint study by the IMF and World Bank chronicled the legitimate versus illegitimate uses of the *hawala* system. The study indicated that the legitimate uses of the *hawala* system consist of: (1) humanitarian, emergency, and relief aid in conflict torn countries; and (2) personal investments and expenditures. Illegitimate uses of the *hawala* system stem from: (1) customs, excise, and income tax evasion; (2) smuggling; (3) money laundering activities; and (4) terrorist financing.

74. OROZCO, *supra* note 49, at 1. Additionally, migration flows are "not unidirectional . . . Greeks migrate to Germany and the United States, while Albanians migrate to Greece. South Africans move to Australia and England, while Malawians, Mozambiqueans, and Zimbabweans work in South African mines and the service industry." *Id.*

75. *Id.* at 4. "International migration gains greater relevance in light of the significant volume of remittances worldwide." *Id.* at 5.

estimates with both skilled and unskilled workers emigrating and global demand for foreign labor increasing.[76] Given the existence of these large migrant-labor communities, the use of the less expensive and more accessible informal *hawala* system is often the only or most convenient option for the remittance of earnings of these migrant laborers to their families.[77] The cheap and swift *hawala* service is in operation "twenty-four hours a day, every day of the year in regions where no banks or financial institutions exist" and, therefore, proves superior to any Western banking operation available to migrant and expert workers.[78]

2. Humanitarian, Emergency, and Relief Aid – White Hawala

The *hawala* system is suited for and often is the only option in countries engaged in war or the rebuilding after war.[79] Consequently, the majority of aid organizations operating in these regions turn to the informal financial sector for international or domestic remittance services for humanitarian, emergency, and relief projects.[80] For many humanitarian organizations the "cost and logistical capacity required for the physical transfer of cash is too high" and to fulfill program goals the informal *hawala* system may be the only option.[81]

3. Personal Investments and Expenditures –White Hawala

The *hawala* system can often be used to transfer funds for legitimate personal investments and expenditures.[82] For some individuals the *hawala* system is simply the most convenient option for expenditures like "travel,

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76. *Id.* at 1.

77. *See* QORCHI ET AL., *supra* note 3, at 7.

78. REZAT, *supra* note 44; *see also* QORCHI ET AL., *supra* note 3, at 12 (describing *hawala* networks as having "wide coverage, serving far-flung locations, including remote villages in Pakistan and Bangladesh, whereas banks may not handle such a small transaction or reach those remote areas within a reasonable time").

79. QORCHI ET AL., *supra* note 3, at 12; *see also* SAMUEL MUNZELE MAIMBO, THE WORLD BANK, THE MONEY EXCHANGE DEALERS OF KABUL: A STUDY OF THE HAWALA SYSTEM IN AFGHANISTAN 1 (2003). In Afghanistan, for example, after more than 20 years of conflict, there has been a complete disruption of formal banking and in the absence of any real banking system a large and vibrant informal market has developed. *Id.*

80. QORCHI ET AL., *supra* note 3, at 12; *see also* POLICY AND ADVOCACY UNIT, CARE USA, AFGHANISTAN: OPTIONS FOR HUMANITARIAN ACCESS 3 (Oct. 2001), http://www.careusa.org/newsroom/specialreports/afghanistan/ahaccess.pdf. "USAID, the single largest donor to the Afghan aid effort, has expressed interest in monetizing some food aid by selling it to Afghan traders." *Id.* In previous years, "cash has been transferred to communities via the '*hawala*' system, giving [refugees] the ability to purchase wheat and other necessities through local traders." *Id.*

81. QORCHI ET AL., *supra* note 3, at 12. "Humanitarian aid organization staff members carry cash when flying into the country for operational duties, but the amounts involved are usually small and meant for overhead expenses, not program needs." *Id.*

82. *Id.*

medical care, or college tuition fees."[83] Consider the example of a Dubai-based, Indian-chartered accountant who reported that when he learned his father was being admitted for emergency bypass surgery in India, the "first thing that came to my mind was *hawala* . . . . [T]he money reached my mother before I did."[84] The accountant commented, "who had the time to go to banks and fill out forms? I just went and gave the money and it was delivered to my mom at the door-step within a day."[85]

4. Smuggling – Black Hawala

While the birth of the *hawala* system may date back centuries, "the growth of the present *hawala* network has its roots in trading and smuggling operations in South Asia in the 1960's and 1970's."[86] In an effort to "avoid gold import restrictions, traders and smugglers used boats to ship gold from places like the Gulf Cooperation Council (GCC) countries to South Asia."[87] To remit funds back to their countries of origin or purchase more gold, traders and smugglers used the growing population of South Asian nationals working in the GCC countries.[88] For instance, *hawaladars* in Dubai, in order to settle their liabilities, would finance gold exports to their counterparts and clients in South Asia.[89]

5. Money Laundering Activities – Black Hawala

Hawala and other IFT systems are vulnerable to abuse at each phase of the money laundering process.[90] Interpol has defined money laundering to embody three phases: (1) placement; (2) layering and; (3) integration.[91] The

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83. *Id.*

84. Namita M. Anand, *Tainted . . . But on the Move,* BUSINESS LINE, Mar. 25, 2002, *at* http://www.blonnet.com/life/2002/03/25/stories/2002032500070100.htm. "For a maid in Singapore the choice between *hawala* and the formal banking channels is clear . . . as there are no banks in her village and her parents are not literate, sending money through *hawala* is simpler, and the *hawala* operator gives her a better rate." *Id.*

85. *Id.*

86. Anderson, *supra* note 18; *see also* QORCHI ET AL., *supra* note 3, at 12 (describing that recent literature attributes the growth of the present *hawala* network, in part, to gold trading and smuggling operations).

87. QORCHI ET AL., *supra* note 3, at 12.

88. *Id.*

89. *Id.*

> The remitting workers received better rates because the *hawaladars* charged higher fees from smugglers who made substantial profits from the gold trade. Thus, the smuggling activities benefited from, and enhanced, the existing system of funds transfers used by expatriates in the Middle East, Southeast Asia, the United Kingdom, and even in North America.

Id. See also Anderson, *supra* note 18.

90. JOST & SANDHU, *supra* note 12; *see also* QORCHI ET AL., *supra* note 3, at 13.

91. JOST & SANDHU, *supra* note 12.

methods used to launder the proceeds of criminal and illegal activities become more complex as time progresses and IFT systems, like *hawala*, are increasingly being used to launder money.[92] The IMF and World Bank have identified several features of IFT systems that can contribute to the placement, layering, and integration of funds. However, both the formal banking sector and the IFT systems are vulnerable to abuse.[93]

The *hawala* system can provide an effective means of placement of money laundering activities.[94] *Hawaladars* often operate businesses outside their *hawala* operations and make periodic bank deposits that can be justified as proceeds from business outside of *hawala* transactions.[95]

Hawala also serves as an appropriate medium to facilitate layering in the money laundering process as *hawala* transfers leave a "sparse" and often "confusing paper trail."[96] From the criminal prospective, laundering money through the formal financial system has the disadvantage of leaving behind documents "that can be traced during an investigation."[97] IFT systems, like *hawala,* can minimize detection because the transactions, which are built upon trust, require little or no documentation.[98] Moreover, even when *hawaladars* maintain records, law enforcement officials cannot readily access them.[99]

In the final phase of money laundering, integration, *hawala* techniques are also susceptible to abuse.[100] *Hawaladars* are capable of transforming money into almost any form, making it possible to establish the appearance of legitimacy.[101] The *hawala* system can be used for money laundering, because the "proceeds can be moved away from the place where a crime was committed

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> In [the] placement [phase] money derived from criminal activities is introduced into the financial system. . . . In the layering stage, the money launderer manipulates the illicit funds to make them appear as though they were derived from a legitimate source. . . . In the final stage of money laundering, integration, the launderer invests in other assets, uses the funds to enjoy his ill-gotten gains or to continue to invest in additional illegal activities.

Id.

92. QORCHI ET AL., *supra* note 3, at 13. Current money laundering methods are diverse and can employ both official banking and informal channels, including exchange bureaus, check-cashing services, insurers, brokers, and non-financial traders. *Id. See also* Ilias Bantekas, *The International Law of Terrorist Financing*, 97 AM. J. INT'L L. 315 (Apr. 2003) (describing that *hawala* networks are used primarily by Muslims to send money to relatives, however, authorities believe they also serve as vehicles to launder money, traffic in drugs and arms, and finance terrorists).

93. QORCHI ET AL., *supra* note 3, at 13. "[N]either system [formal or informal] necessarily involves the physical transfer of funds from one jurisdiction to another. Instead, they depend on a series of accounting debits and credits between the accounts of a network of individuals, companies, accountants, lawyers, and intermediaries." *Id.*

94. JOST & SANDHU, *supra* note 12.

95. *Id.*

96. *Id. See also* QORCHI ET AL., *supra* note 3, at 13.

97. QORCHI ET AL., *supra* note 3, at 13.

98. *Id.*

99. *Id.*

100. JOST & SANDHU, *supra* note 12.

101. QORCHI ET AL., *supra* note 3, at 13.

to destinations where the transaction can either appear legitimate or from where it can be later brought back to the country through a variety of legitimate routes for the integration process."[102]

6. Terrorist Financing – Black Hawala

Concerns have been raised about using *hawala* as an instrument to fund terrorists.[103] The lack of requirements for identification or inquiries into the source is an important facet of *hawala* transactions. It allows dealers to "facilitate a multiplicity of transfers, which conceal the ultimate origin of the funds through their network in different jurisdictions."[104] For example, international attention was directed at the *hawala* system when investigators traced an anonymous fund transfer by Al-Qaeda operatives involved in the September 11 terrorist attacks. The fund transfer trail led investigators to a money transfer from a Boston transfer facility to a suspected Al-Qaeda functionary in a exchange house in the United Arab Emirates.[105]

7. Macro-Economic Implications of Informal Fund Transfer Systems

While the direct impact on the policy options of IFT systems is not readily apparent, IMF studies suggest that the impact on a country's domestic "monetary and exchange rate policy choice[s] can be significant."[106] *Hawala* transactions are not reflected in a country's official statistics as the remittance of funds from one country to another and therefore, are not officially recorded.[107] Consequently, (1) the data available to policymakers does not offer an accurate picture of the "economic and monetary situation of [the] country;" and (2) *hawala* transactions have fiscal implications for both remitting and receiving countries.[108]

A *hawala* transaction is intrinsically related to changes in international assets and liabilities in a nation and is, conceptually, part of a country's balance of payment accounts.[109] Therefore, as national authorities are unable to maintain records of informal financial transfers, these informal transactions reduce "the amount of statistical information available to policymakers on the level of economic activity in the country."[110]

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102. *Id.*
103. *Id.*
104. *Id.*
105. K. Raveenran, *U.A.E. Takes Unprecedented Action on Hawala*, THE DAILY STAR, Oct. 25, 2003, at 5, *available at* http://goldismoney.info/forums/archive/index.php/t-4556.html.
106. QORCHI ET AL., *supra* note 3, at 18.
107. *Id.* at 26. "The remittances of funds from one country to another is not recorded as an increase in the recipient's country's foreign assets or in the remitting country's liabilities." *Id.* at 18.
108. *Id.*
109. *Id.*
110. *Id.* at 27.

Moreover, IFT systems have "fiscal implications" affecting "both remitting and recipient countries."[111] First, as one of the characteristics of *hawala* indicate, it operates in a largely informal and unregulated environment, thus revenue collection structures for these transactions do not exist.[112] Additionally, as the business settlement accounts between *hawala* operators are not documented a government "may incur losses in its customs and excise duty revenue."[113]

PART TWO: INTERNATIONAL EFFORTS TO REGULATE *HAWALA*

A. Introduction

International legislation in the area of IFT systems has concentrated on curbing the tendency for systems like *hawala* to be used for illegitimate purposes like smuggling, money laundering and terrorist financing.[114] The organization that has emerged as the cornerstone of the international effort to encourage countries to regulate IFT systems like the *hawala* system is the Financial Action Task Force armed with its legislative initiative titled The Forty Recommendations (The Recommendations).[115]

1. Financial Action Task Force

The Financial Action Task Force (FATF) was created in July 1989 by the governments of the seven major industrial nations (G-7).[116] FATF has been

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111. *Id.*

112. *Id. Hawala* operations are typically not taxed by the government as they are unrecorded transactions. *Id.*

113. *Id.*

114. FATF Secretariat, OECD, *Report on Money Laundering Typologies*, Doc. FAFT-XI (Feb. 3, 2000), *available at* http://www1.oecd.org/fatf/FATDocs_en.htm.

115. FATF Secretariat, OECD, *The Forty Recommendation* (June 20, 2003), http://www1.oecd.org/fatf/pdf/40Recs-2003_en.pdf [hereinafter *Forty Recommendations*].

116. Jonathan Schaffer ed., *The Financial Action Task Force on Money Laundering*, ELEC. J. OF U.S. DEPT. OF STATE Vol. 6 No. 2, May 2001, *at* http://usinfo.state.gov/journals/ites/0501/ijee/fatffacts.htm. The G-7 is currently comprised of the heads of state of Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States. *Id. See also* WILLIAM C. GILMORE, DIRTY MONEY: THE EVOLUTION OF MONEY LAUNDERING COUNTERMEASURES 79 (1999). At their 1989 Paris Summit, the governments of the seven major industrial nations (G-7) joined by the president of the commission of the European Communities, created FATF to address issues of "drug production, consumption and trafficking" and the "laundering of its proceeds." *Id.* FATF is now comprised of twenty-nine nations and two jurisdictions, the membership of the FATF includes Argentina, Australia, Austria, Belgium, Brazil, Canada, Denmark, Finland, France, Germany, Greece, Hong Kong, China, Iceland, Ireland, Italy, Japan, Luxemburg, Mexico, The Kingdom of the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, Turkey, The United Kingdom, and the United States, as well as two regional organizations: The European Commission and the Gulf Co-Operation Council. Financial Action Task Force, *Members and Observers*, *at* http://www1.oecd.org/

hailed as the "single most important international body in terms of the formulation of anti-money laundering policy."[117] In furtherance of its mission, in 1990, FATF issued a forty-point list of recommendations on money laundering countermeasures.[118] These recommendations constitute an initiative to combat the misuse of financial systems by persons laundering money. They proscribe a range of actions focusing on "improvements in national legal regimes, enhancement of the role of the financial system, and strengthening international cooperation."[119]

FATF places far-reaching responsibilities on financial institutions.[120] The Recommendations encourage the "banking sector to adopt a common position in order to ensure that banks are not used to hide or launder funds acquired through criminal activities."[121] Also, The Recommendations urge financial institutions to make reasonable efforts to: (1) determine the true identity of customers and have procedures for verifying new customers;[122] (2) ensure that business is conducted in conformity with ethical standards, that laws and regulations are adhered to and that a service is not provided where there is good reason to suppose that transactions are associated with laundering activities;[123] (3) co-operate fully with national law enforcement agencies including, where there are reasonable grounds for suspecting money laundering, taking appropriate measures consistent with the law;[124] and (4) implement staff training for procedures for customer identification and for retaining internal records of transactions.[125]

Additionally, in October 2001, FATF expanded its mission beyond money laundering to focus energy and expertise on a worldwide effort to combat terrorist financing.[126] FATF issued Eight Special Recommendations[127]

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fatf/Members_en.htm# OBSERVERS (last updated Jan. 31, 2005) (last visited Mar. 25, 2005).

117. GILMORE, *supra* note 116, at 79.

118. *See Forty Recommendations*, *supra* note 115.

119. Ronald K. Noble & Court E. Golumbic, *A New Anti-Crime Framework for the World: Merging the Objective and Subjective Models for Fighting Money Laundering*, 30 N.Y.U. J. INT'L L. & POL. 79, 118 (1997); *see also Forty Recommendations*, *supra* note 115.

120. *See* GILMORE, *supra* note 116, at 86. The common theme concerning recommendations is the view "that financial institutions are the key element in the detection of illicit transactions given their unique function in a country's payments system and in the collection and transfer of financial assets." *Id.*

121. *Id.* Recommendations Nine to Twenty-Nine outline a "strategy to engage the financial system in the effort to combat laundering while . . . seeking to ensure the retention of the conditions necessary for its efficient operation." *Id.* at 86.

122. *Forty Recommendations*, *supra* note 115, at 2. *See also* GILMORE, *supra* note 116, at 86 (discussing "know your customer" provisions of the FATF Recommendations); Noble & Golumbic, *supra* note 119, at 119 (stating that Forty Recommendations "advise that financial institutions should refuse to maintain anonymous accounts or accounts with obviously fictitious names").

123. *Forty Recommendations*, *supra* note 115, at 5.

124. *Id.* at 8.

125. *Id.* at 6.

126. FATF, OECD, *The Eight Special Recommendations on Terrorist Financing*, *at* http://www.fatf-gafi.org/AboutFATF_en.htm#Eight%20Special%20Recommendations (Oct. 31, 2001) [hereinafter *Special Recommendations*].

on international standards for combating terrorist financing and called upon nations to adopt and implement them.[128] Relevant among these recommendations is Special Recommendation VI, dealing with the abuse of alternative remittance systems.[129] This recommendation is based on the presumption that IFT systems, like *hawala*, have shown themselves to be "vulnerable to misuse for money laundering and terrorist financing purposes."[130] The objective of Special Recommendation VI is to "increase the transparency of payment flows by ensuring that jurisdictions impose consistent anti-money laundering and counter-terrorist financing measures on all forms of money/value transfer systems, particularly those traditionally operating outside the conventional banking sector and not subject to FATF Recommendations."[131] To this end, the special recommendation calls upon:

> Each country [to] take measures to ensure that persons or legal entities, including agents, that provide a service for the transmission of money or value, including transmission through an informal money or value transfer system or network, should be licensed or registered and subject to all the FATF Recommendations that apply to banks and non-bank financial institutions. Each country should ensure that persons or legal entities that carry out this service illegally are subject to administrative, civil or criminal sanctions.[132]

Special Recommendation VI consists of three key elements. First, the recommendation calls for jurisdictions to require "licensing or registration of persons (natural or legal) that provide money/value transfer services, including through informal systems."[133] Secondly, the recommendation suggests that

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127. *Id.* The Eight Special Recommendations include:

> (I) Ratification and Implementation of UN Instruments; (II) Criminali[z]ing the Financing of Terrorism and Associated Money Laundering; (III) Freezing and Confiscating Terrorist Assets; (IV) Reporting Suspicious Transactions related to Terrorism; (V) International Co-operation; (VI) Alternative Remittance; (VII) Wire Transfers; (VIII) Non-Profit Organi[z]ations.

Id.

128. *Id.*

129. *Id.* ¶ VI.

130. FATF, OECD, *Interpretive Note to Special Recommendation VI: Alternative Remittance*, *at* http://www1.oecd.org/fatf/TFInterpnotes_en.htm#Special%20Recommendation%20VI (last updated Feb. 2, 2005) (last visited Feb. 27, 2005) [hereinafter *Interpretive Note*].

131. *Id.*

132. *Special Recommendations*, *supra* note 126, ¶VI.

133. *Interpretive Note*, *supra* note 130. According to the Special Recommendation VI, "licensing means a requirement to obtain permission from a designated competent authority in order to operate a money/value transfer service legally." *Id.* To this end:

> Jurisdictions should designate an authority to grant licenses and/or carry out registration and ensure that the requirement is observed. There should be an authority responsible for ensuring compliance by money/value transfer services with the FATF Recommendations (including the Eight Special Recommendations). There should also be effective systems in place for

jurisdictions "ensure that money/value transmission services, including informal systems . . . are subject to applicable FATF Forty Recommendations and the Eight Special Recommendations."[134] Finally, the recommendation calls on jurisdictions to impose sanctions on money/value transfer services, including informal systems that operate without a license or registration and "which fail to comply fully with the relevant FATF Forty Recommendations or the Eight Special Recommendations . . . ."[135]

Pursuant to its mission, FATF has taken a unique role by stressing the importance of implementing its initiatives by member and non-member jurisdictions.[136] To this end, FATF has set up four regional review groups to assess the anti-money laundering regulations in a number of jurisdictions against a list of twenty-five "Criteria Identifying Detrimental Rules and Practices that Impede International Cooperation," which FATF compiled in light of the Forty Recommendations and the Eight Special Recommendations.[137]

Following this review, FATF releases a list of non-cooperative countries.[138] After being identified as a "non-cooperative" jurisdiction, FATF urges the "non-cooperative" states to execute measures to improve their legal and financial systems as "expeditiously as possible in order to remedy the . . . deficiencies identified in the reviews."[139] Additionally, in accordance with Recommendation Twenty-One, FATF advises that "[f]inancial institutions should give special attention to business relationships and transactions with persons, including companies and financial institutions," from the non-cooperative countries.[140] Furthermore, FATF announced that should the countries identified as "non-cooperative" fail to make necessary reforms, FATF members may consider adopting countermeasures against such jurisdictions.[141] FATF has also announced its preparedness "to provide technical assistance" to

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monitoring and ensuring such compliance. . . .

Id.

134. *Id.* In particular, applicable Recommendations include 10-21 and 26-29. According to the scope and application of Special Recommendation VI, a money or value transfer service may be provided by persons (natural or legal) through the regulated financial system or informally through non-bank financial institutions or through a network or mechanism that operates outside the regulated system, like *hawala*. *See id.*

135. *Id.*

136. FATF Secretariat, OECD, *Review to Identify Non-Cooperative Countries or Territories: Increasing the Worldwide Effectiveness of Anti-Money Laundering Measures* 3 (June 20, 2003), http://www1.oecd.org/fatf/pdf/NCCT2003_en.pdf [hereinafter *FATF 2003 Review*].

137. *Id.* at 3; *see also* Todd Doyle, *Cleaning Up Anti-Money Laundering Strategies: Current FATF Tactics Needlessly Violate International Law*, 24 HOUS. J. INT'L L. 279, 295 (2002) (describing the four regional review groups to consist of "the Americas, Asia/Pacific, Europe, and Africa and the Middle East").

138. *FATF 2003 Review*, *supra* note 136, at 3.

139. *Id.* at 17.

140. *Forty Recommendations*, *supra* note 115, at 7.

141. *FATF 2003 Review*, *supra* note 136, at 5.

assist jurisdictions in the design and implementation of their anti-money laundering systems.[142]

Indeed, since the establishment of FATF more than a decade ago, and the subsequent broadening of its mission, FATF has been instrumental in influencing both member and non-member nations in "instituting more rigorous reporting procedures within banks and other financial institutions," as well as establishing an extensive system of "peer review to assure compliance with FATF guidelines."[143] Generally, FATF strategy has elicited an "immediate response from targeted nations."[144]

2. Comments on the Financial Action Task Force Recommendations

However, where FATF is to be commended in its widely adopted approach, the group's strategy, centered on licensing requirements for *hawala* and other IFT brokers, does not entirely account for reducing the economic incentives for a country's citizens and ex-patriots to engage in IFT systems, like the *hawala* system.[145] Registration and licensing requirements, although likely to deter illegal activities, will not succeed in reducing the economic attractiveness of the *hawala* system.[146] The emergence of *hawala* can be described as a "market response by economic agents to their economic environment."[147] Taken in this context, the international community should apply conclusions reached by the IMF and World Bank and focus its policy goals on combating the economic incentives to engage in *hawala* transactions. These incentives include: (1) inefficient and inadequate banking infrastructures; (2) lack of comparable alternatives to *hawala*; and (3) deficient global coordination and capacity building.[148]

According to IMF and World Bank assessments, the *hawala* system should be understood as an "informal means of transferring funds" across borders used by individuals "constrained by the level of financial development and government policies" in their home countries.[149] Generally, the growth of IFT systems is "negatively correlated with the level of development and liberalization of the formal financial sector."[150] The attraction to IFT systems is increased in countries where inefficient banking institutions operate in environments that include strict foreign exchange controls and heightened state

142. Doyle, *supra* note 137, at 296.

143. *Id.* at 294.

144. *Id.* at 296 (describing that Liechtenstein, the Bahamas, and the Philippines have "each scrambled to review their regulatory schemes and to enact new measures bringing their banking laws up to compliance with FATF standards").

145. Wilson, *supra* note 5, at 12.

146. EL-QORCHI, *supra* note 13.

147. Congressional Hearing, *supra* note 45, at 44.

148. *Id.*

149. *Id.*

150. QORCHI ET AL., *supra* note 3, at 26.

intervention in the market.[151] Where developed registration and licensing requirements will add a degree of official scrutiny to *hawala* operators, the ultimate incentives for *hawala* customers to engage these services will not change.[152] Indeed, "relaxing or abolishing currency restrictions and controls" through "liberalization of interest rates, removal of income taxes on remittances from overseas and lifting restrictions on duties" could encourage business away from *hawaladars*.[153]

Moreover, current formal remittance systems operating through banks and institutions like Western Union and MoneyGram are not competitive enough to draw customers away from *hawaladars*.[154] Registration and licensing requirements that are imposed on *hawala* operators do not address the economic competitive advantage enjoyed by *hawaladars*, and as long as such discrepancies endure *hawala* and other IFT systems will "continue to thrive and fill important gaps left by conventional society at the regional and international level[s]."[155] If the formal banking sector intends to compete with the informal remittance business, it should "focus on improving the quality of its service and reducing the fees charged."[156]

Additionally, developing international regulatory standards for IFT systems is a complicated procedure.[157] The growth IFT systems have enjoyed "over many years and across many countries points to the important role that these systems can play in the absence of a robust and efficient formal financial sector."[158] Indeed, "[d]ifferences in the stages of economic" and political development demands that international regulations give consideration to "country specific circumstances and national legal systems."[159] Often, prescribing regulations through licensing requirements will not ensure compliance.[160]

Applying these IMF and World Bank conclusions to efforts to regulate *hawala* in India, Pakistan and the United Arab Emirates amplifies the weakness

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151. *Id. See also* NIKOS PASSAS, RESEARCH AND DOCUMENTATION CENTRE OF THE DUTCH MINISTRY OF JUSTICE, INFORMAL VALUE TRANSFER SYSTEMS AND CRIMINAL ORGANIZATIONS, A STUDY INTO SO CALLED UNDERGROUND BANKING NETWORKS 70, http://minjust.nl:8080/b_organ/wodc/publications/ivts.pdf (n.d.) (last visited Feb. 15, 2005) (describing that the "faith of Pakistanis in banks and government was undermined when foreign currency deposits were frozen" and "citizens were only allowed to withdraw local currency").

152. Wilson, *supra* note 5.

153. PASSAS, *supra* note 151, at 70. *But see* Wilson, *supra* note 5 (recognizing that strict foreign exchange controls are important tools of fiscal policy in the hands of governments seeking to stabilize their economy, which also have the effect of encouraging *hawala*).

154. *See* EL-QORCHI, *supra* note 13.

155. PASSAS, *supra* note 151, at 70.

156. EL-QORCHI, *supra* note 13. "A longer-term and sustained effort should be aimed at modernizing and liberalizing the formal financial sector, with a view of addressing its inefficiencies and weaknesses." *Id.*

157. QORCHI ET AL., *supra* note 3, at 27.

158. *Id.*

159. *Id.*

160. *Id.*

behind a purely economic based strategy. An evaluation of the merits behind these countries strategies will reveal the *dual* importance economic and political factors can play in a successful strategy to regulate the *hawala* system.

PART III: *HAWALA* CASE STUDIES: INDIA, PAKISTAN AND UNITED ARAB EMIRATES

A. India

1. Hawala in India and India's Response

Estimates indicate that "ten billion of the fourteen billion dollars sent to India each year currently passes through unofficial channels," like the *hawala* system.[161] Consequently, the Indian government has adopted firm measures with respect to the regulation of its informal market, in particular the *hawala* system, with the passage of two acts: The Financial Exchange Regulation Act (FERA)[162] and its later consolidated and amended version, The Financial Exchange Management Act (FEMA).[163] These acts have explicitly prohibited "*hawala*-type" transactions.[164]

FERA, enacted in 1973, was drafted with the objective of introducing regulations for the entry of foreign capital into India's economy.[165] It represents the Indian legislature's efforts to combat the extensive *hawala* system that continues to flourish in India.[166] As a result of "major changes in the Indian economy and liberalization of industrial and trade policies" in line with India's changed international economic and trade relations, the Indian legislature saw the "need for a more conducive climate for increased inflow of foreign investment and capital . . . to accelerate . . . growth."[167] FERA contained certain important "special restrictions in regard to foreign investment and the activities of individuals" engaged in foreign exchange, in particular the *hawala* system.[168]

Under FERA, sections eight and nine provided "detailed legal prohibitions on the *hawala* market."[169] Section eight, for instance, placed

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161. Gudka, *supra* note 18.

162. Foreign Exchange Regulation Act, No. 46 (1973) (India) [hereinafter FERA].

163. Foreign Exchange Management Act, (1999) (India) [hereinafter FEMA].

164. QORCHI ET AL., *supra* note 3, at 22. "The number of institutions . . . permitted to deal in foreign exchange has been closely defined, and the kinds of transactions permitted for customers . . . have been revised." *Id.*

165. INDIA INFO LAW, AN INTRODUCTION TO FOREIGN EXCHANGE REGULATION ACT 1973, http://law.indiainfo.com/foreign-exchange/introduction.html (n.d.) (last visited Feb. 25, 2005) [hereinafter INTRODUCTION TO FERA 1973].

166. *Id.*

167. *Id.*

168. *Id.*

169. Taxmann's Guide to Foreign Exchange Management Act, *Hawala Transactions*, Rashmin Sanghvi & Associates, *at* http://www.rashminsanghvi.com/femabook5.htm (1999)

restrictions on individuals who could engage transactions in foreign currency as well as restraints on conversions between Indian currency and foreign currency.[170] In particular, section eight imposed strict licensing requirements on money changers and prohibited the acquiring, borrowing, selling, or transferring of foreign exchange from persons other than an "authori[z]ed dealer" in India.[171] Moreover, section eight regulated persons other than authorized dealers or money changers and imposed on them requirements to sell any foreign exchange acquired to an authorized dealer in an effort to legislatively force funds from the informal market into the formal market.[172] Additionally, section nine of FERA specifically covered domestic transactions.[173] Section nine of FERA specifically restricted *hawala* transactions by prohibiting the making of any payment or credit to any person outside of India without conditional approval from the Indian Reserve Bank.[174] The remaining clauses in section nine of FERA supported the acts "main target of preventing the flight of capital from India through any channel."[175] In 1993, FERA was revised and several amendments were enacted as part of the on-going process of India's economic liberalization relating to foreign investment and foreign trade for closer interaction with the world economy.[176]

Taking into consideration the substantial financial developments in India since the passage of FERA, a bill to replace certain provisions of the act was introduced into the Indian legislature in August 1998.[177] FEMA reintroduces

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(last visited Mar. 24, 2005) [hereinafter Taxmann's Guide].

170. FERA § 8.

171. *Id.* § 8(1). For purposes of section eight "a person, who deposits foreign exchange with another persons or persons or opens an account in foreign exchange with another person, shall be deemed to lend foreign exchange to such other person." *Id.*

172. *Id.* § 8(3). This section provides that:

> Where an foreign exchange is acquired by any person, other than an authori[z]ed dealer or money changer, for any particular purpose, or where any person has been permitted conditionally to acquire foreign exchange, the said person shall not use the foreign exchange so acquired otherwise than for that purpose . . . the said person shall, within a period of thirty days from the date on which he comes to know that such foreign exchange cannot be so used or the conditions cannot be complied with, sell the foreign exchange to an authorized dealer or to a money-changer.

173. *Id.* § 9.

174. *Id.* § 9(f). See also FERA § 9(1), explaining that for the purposes of section nine:

> [W]here any person in, or resident in, India receives any payment by order or on behalf of any person resident outside India through any other person (including an authori[z]ed dealer) without a corresponding inward remittance from any place outside India, then, such person shall be deemed to have received such payment otherwise than through an authori[z]ed dealer.

Id. § 9(1).

175. Taxmann's Guide, *supra* note 169, ch. 5.1; *see also* FERA § 9.

176. INTRODUCTION TO FERA 1973, *supra* note 165; *see also* INDIA INFO LAW, FOREIGN EXCHANGE MANAGEMENT ACT (FEMA) 1999 TO REPLACE FOREIGN EXCHANGE REGULATION ACT (FERA), *at* http://law.indiainfo.com/foreign-exchange/fema.html (last visited Oct. 20, 2003).

177. *See* FEMA.

and expands upon FERA's concept of licenses for moneychangers.[178] In particular, Chapter Two of FEMA prohibits persons from "enter[ing] into any financial transaction in India as consideration for or in association with acquisition or creation . . . of a right to acquire, any asset outside India by any person."[179] Additionally, FEMA provides for a heightened role of the Reserve Bank of India (Reserve Bank) in regulating these transactions by specifying that the Reserve Bank, in consultation with the Central Government, may specify: "(a) any class or classes of capital account transactions which are permissible; and (b) limit which foreign exchange shall be admissible for such transactions."[180]

Additionally, the Reserve Bank, on a limited basis, has attempted to "increase the efficiency and cost effectiveness of banking services" in an effort to make IFT services, like *hawala*, "seem less attractive."[181] Indeed, bank branch expansions in the 1970s and 1980s improved access to the formal banking sector by reducing the "per branch population."[182] More recently, the Reserve Bank has allowed non-bank financial institutions to undertake "money transfer service schemes to facilitate swift and easy transfer of personal remittances from abroad to beneficiaries in India."[183] These schemes, operating through computerized post offices, are hoped to be more popular because money can now be received in less than ten minutes.[184] Moreover, the Indian Post Office also expects to profit off the service by obtaining ten percent of the share of remittances sent through the facility.[185]

Beyond these measures, the government in India has established a special federal police unit with the sole function to fight economic crime, consistent with FATF Recommendation Twenty-Seven, calling on nations to "ensure that designated law enforcement authorities have responsibility for money laundering and terrorist financing investigations."[186] The unit's mission is to tackle economic crimes like bank fraud and the movement of money from foreign countries through informal fund transfer systems.[187] Furthermore, this

178. *See id.* at ch. 2; *see also* Taxmann's Guide, *supra* note 169, ch. 5.3.

179. FEMA ch. 2(d); *see also* QORCHI ET AL., *supra* note 3, at 22 (describing that the recent FEMA specifically addresses *hawala*-type transactions by "prohibiting Indian residents from entering 'into any financial transaction in India as consideration for or in association with acquisition or creation or transfer of a right to acquire any asset outside India by any person'"). *Id.*

180. FEMA ch. 2(a)-(b).

181. QORCHI ET AL., *supra* note 3, at 23.

182. *Id.*

183. *Id.*

184. Gudka, *supra* note 18. India launched the money ordering facility "in the United Arab Emirates to make it quicker for the large number of Indian expatriates there to send money home." *Id.*

185. *Id.*

186. PASSAS, *supra* note 151, at 62; *see also Forty Recommendations*, *supra* note 115, at 8 (describing institutional and other measures necessary in systems for combating money laundering and terrorist financing).

187. PASSAS, *supra* note 151, at 62.

unit is designed to target *hawala* brokers by reducing the amount of money sent through the IFT system as well as diverting funds to the regulated banking industry through strict enforcement of banking laws and extensive investigations of *hawala* operations.[188]

2. *Assessment of Indian Regulations*

Although the Indian government has attempted to tackle its informal fund transfer industry since the early 1970's, its strict legislative guidelines, which essentially ban *hawala* transactions, have largely backfired.[189] This is attributable to several flaws in India's policy and government structure, specifically with respect to the lack of recognition by the Indian legislature that "where strong commercial interests tempt; no amount of legal restrictions will be successful."[190] Indeed, the roots of *hawala* transactions are firmly embedded in the Indian economic and, perhaps more importantly, political atmosphere and has worked to usher in an era of "bad politics" and corruption that has become indicative of the Indian democracy.[191]

Despite the Indian Government's most restrictive legal provisions, *hawala* remains a "routine transaction."[192] Analysts indicate that people continue to transfer capital outside of India at their "sweet will."[193] Indeed, the Indian regulation of *hawala* is a typical example of where even the most severe licensing provisions cannot ensure compliance.[194] Since the Indian rupee continues to depreciate, "wealthy people seeking to protect the value of their wealth have a strong economic interest in transferring their wealth outside India."[195]

Moreover, the Indian case is unique in that even the most restrictive licensing requirements will have little impact on *hawala* transactions given the extent of corruption evident in Indian politics.[196] Indeed, the Jain *Hawala* Scandal, which implicated top Indian politicians and bureaucrats for accepting illicit payment through *hawala* channels, amplifies this point.[197] In that case, the Indian Central Bureau of Investigation (CBI), while investigating a case "pertaining to funding of Jammu and Kashmir militants, raid[ed] a house in Delhi seizing account books" implicating India's rich and powerful, including the Prime Minister at the time, P.V. Narasimha Rao, in receiving funds through

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188. *Id.*

189. *See id.* (describing that though the liberalization of the Indian economy was supposed to "help fight the prevalence of *hawala*... the problem continues almost unabated"). *Id.* at 63.

190. Taxmann's Guide, *supra* note 169, ch. 5(5)(1).

191. *See* SANJAY KAPOOR, BAD MONEY, BAD POLITICS: THE UNTOLD *HAWALA* STORY 88 (1996).

192. Taxmann's Guide, *supra* note 169, ch. 5(5)(1).

193. *Id.*

194. *See* discussion, *supra* Part Two B.

195. Taxmann's Guide, *supra* note 169, ch. 5(5)(1).

196. *See* KAPOOR, *supra* note 191, at 84.

197. *See id.*

India's illegal *hawala* market.[198] Twenty-four politicians were ultimately charged with being "beneficiaries of [sixty-four million] rupees in bribes and gifts" from businessmen.[199]

The Indian case, particularly with respect to its *hawala* scandal, illustrates that a nation's stage of economic, financial, and political development must be taken into account when formulating regulatory strategies, particularly with respect to IFT systems like the *hawala* system that are so firmly rooted in that country's financial and political being.[200] In a developing country like India, criminal elements already exploiting *hawala* transactions have a strong incentive to infiltrate the political structure to ensure their survival and are able to find willing partners in Indian politicians who "have not seen big money, and they need these funds to win an extremely costly election[s]."[201] Moreover, FATF recommendations, which rely heavily on strong criminal justice infrastructures to enforce licensing requirements, are disadvantaged in India where high ranking Indians are able to escape prosecution unscathed.[202] Indeed, Narasimha Rao survived "numerous corruption scandals in government," the worst of them being a payment to "escape prosecution in [a] stock market scam."[203]

B. Pakistan

1. Hawala in Pakistan and Pakistan's Response

The *hawala* system in Pakistan operated in a predominantly unregulated environment for years,[204] having only recently come under more focused

198. KAPOOR, *supra* note 191; *see also Jain Hawala Case Rocks India*, Mahendra Agaarwal Online, *at* http://mahendra-agarwalonline.20m.com/PR_JainHawalaCase.htm (Mar. 2, 1996) [hereinafter *Jain Hawala Case*].

199. *Jain Hawala Case*, *supra* note 198. The Jain *Hawala* case implicated high ranking officials in India including "seven serving Cabinet ministers, all of whom have resigned; the president of the leading opposition Bharatiya Janata Party, who gave up his parliamentary seat; and the chief minister of the local government in New Delhi, who also quit." *Id.*

200. *See* QORCHI ET AL., *supra* note 3, at 28. In this joint IMF and World Bank study the authors conclude that for the regulation of the *hawala* system will among other things depend on "the ability of the formal financial sector to respond to the legitimate market demand for *hawala* type transactions." *Id.* This conclusion can be expanded, using the Indian case, to include comprehensive political reforms to ensure compliance with regulations.

201. KAPOOR, *supra* note 191, at 88.

202. *See id.*

203. *Hard Times*, NEWS INSIGHT, Oct. 8, 2003, *at* http://www.indiareacts.com/archivedebates/nat2.asp?recno=736&ctg=. "Although there is no rule on the effect of corruption charges on political careers in India few politicians are said to hit rock bottom." *Id.*

204. *See Experts Urge Measured Regulation of 'Hawala' Monetary Transfers*, ARAB AMERICAN BUSINESS, *at* http://www.arabamericanbusiness.com/June2002/intbus_expertsurgemeasured.htm (n.d.) (last visited Sept. 27, 2003) [hereinafter Arab American Business]. "Mohammed al-Qorschi, a senior economist with the International Monetary Fund," reported that Pakistan alone "received around $5 billion a year through paperless transactions." *Id.*

legislative scrutiny.[205] Indeed, it has been reported that the State Bank of Pakistan (SBP), prior to undergoing policy refinements, had periodically made large "outright dollar purchases from offshore moneychangers."[206] Moreover, with a large number of Pakistanis living abroad and seeking to remit funds back to Pakistan, the Pakistani economy has undergone "a long history of various forms of capital controls."[207] To this end, Pakistan has "tried to encourage capital to stay in Pakistan" or eventually flow into the regulated financial system through two early initiatives: (1) the Foreign Exchange Bearer Certificates (FEBCs) Scheme in 1985; and (2) the Foreign Currency Bearer Certificates in 1992 (FCBCs).[208] The aim of these initiatives was to "attract funds from Pakistanis abroad and to reduce the attraction of *hundi* and the *hawala* networks in the country."[209]

Post September 11, Pakistan, under pressure from the United States and the International Community, has "crack[ed] down on money laundering and regulating the *hawala* fund-transfer system."[210] The SBP recently issued a report titled, "Islamic Finance and Pakistan's Efforts in the Financial War on Terrorism," which highlighted Pakistan's revitalized effort in the financial war on terrorism and money laundering.[211] In that report, Pakistan details its revised approach to banking through adopting the recommendations of FATF and "actively participating as a member" of that group's regional Asia-Pacific Group on Money Laundering.[212] Indeed, Pakistan, after reviewing its existing banking systems and procedures, has developed a "multiple track strategy" to reign in *hawala* markets, the main elements of which include: (1) the development of comprehensive legislation to fill in the gaps and loopholes in the existing laws, and "empower and streamline the procedures for monitoring, detection, reporting, investigation, [and] prosecution of offenses;" and (2) the

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205. *See* Jawaid Bokhari, *U.S. For Anti-Money Laundering Regime,* DAWN INTERNET EDITION, June 23, 2001, http://www.dawn.com/2001/06/23/top14.htm. The US State department advised Pakistan to establish a system of reporting suspicious transactions by all financial institutions. *Id.* The Pakistani Government has "promulgated new ordinances addressing various financial crimes" but Pakistan does not have a financial intelligence unit. *Id.*

206. Nadeem Malik, *U.S. for Tough Anti-Money Laundering Law*, THE INT'L NEWS, Sept. 20, 2003, *at* http://www.jang.com.pk/thenews/sep2003-daily/20-09-2003/main/main4.htm. It is reported that the State Bank of Pakistan purchased $1.4 billion in 2001-2002. *Id.*

207. QORCHI ET AL., *supra* note 3, at 22.

208. PASSAS, *supra* note 151, at 63-64. The FCBCs were "timed rather badly" as its "issuance coincided with the close down of . . . a bank managed by Pakistani's . . . amid accusations of unprecedented fraud, corruption and money laundering." *Id.*

209. *Id.*

210. *Snow Praises Pakistan's Moves to Choke Off Terrorism Funding*, NEWS CHANNEL 8, Sept. 19, 2003, http://www.news8.net/news/stories/0903/103235.html [hereinafter *Snow Praises Pakistan*].

211. ISHRAT HUSAIN, STATE BANK OF PAKISTAN, ISLAMIC FINANCE AND PAKISTAN'S EFFORTS IN THE FINANCIAL WAR ON TERRORISM ¶ 1, http://www.sbp.org.pk/about/speech/2003/23-apr-03.htm (n.d.) (last visited Feb. 4, 2005).

212. *Id.*

strengthen the regulatory and supervisory capacity of the Pakistani government.[213]

Under the first element of Pakistan's strategy the informal market will be allowed to "co-exist along with the conventional banks."[214] To this end, the Governor of the SBP has prepared a draft act that conforms to FATF standards.[215] The law would require profiling of all the account holders, "both existing and new, to detect suspicious transactions."[216] These measures are an in conformity with FATF Recommendations Thirteen and Fourteen calling on nations to encourage reporting of suspicious transactions.[217] Moreover, Pakistan's new profiling procedures are consistent with FATF Recommendations designed to curb the anonymity associated with *hawala* transactions by calling on financial institutions to "undertake customer due diligence measures, including identifying and verifying the identity of . . . customers."[218]

Within Pakistan's strategy to develop comprehensive legislation, Pakistani President Pervez Musharraf's government passed a law that requires "*hawala* dealers to register with the government and document their transactions."[219] This law is consistent with FATF Special Recommendation VI containing a core requirement for jurisdictions to require licensing or registration of persons that provide money transfer services.[220] The newly promulgated legal framework calls for the "transformation of money changers into foreign exchange companies" and "allows money changers a two-year period to register" and comply with the new rules.[221]

Under the second element of Pakistan's comprehensive strategy, the SBP, Securities Exchange Commission of Pakistan (SECP),[222] and the National

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213. *Id.*

214. *Id.* ¶ 2

215. Malik, *supra* note 206.

216. *Id.*

217. *Forty Recommendations*, *supra* note 115, at 5. FATF Recommendation Thirteen states that:

> If a financial institution suspects or has reasonable grounds to suspect that funds are the proceeds of a criminal activity, or are related to terrorist financing, it should be required, directly by law or regulation, to report promptly its suspicions to the financial intelligence unit.

Id.

218. *Forty Recommendations*, *supra* note 115, at 2. This recommendation calls on financial institutions to "not keep anonymous accounts or accounts in obviously fictitious names." *Id.*

219. *Snow Praises Pakistan*, *supra* note 210.

220. *Id. See also Interpretive Note*, *supra* note 130 (describing that Special Recommendation VI consists of three core elements).

221. QORCHI ET AL., *supra* note 3, at 22.

222. The SECP was created in 1997 by the Securities Exchange Commission of Pakistan Act and "succeeded the Corporate Law Authority which had been administering the corporate laws in Pakistan since 1981." Securities and Exchange Commission of Pakistan, *About Us*, *at* http://www.secp.gov.pk/aboutus.htm (n.d.) (last visited Feb. 25, 2005).

Accountability Bureau (NAB)[223] have developed distinct and identifiable responsibilities consistent with FATF recommendation Twenty-Seven.[224] Under the new system, the

> State Bank of Pakistan will be responsible for regulation, supervision, detection and reporting in respect of all the banking institutions; SECP for non-bank finance companies and NAB for investigation and prosecution. [The] Anti-Narcotic Force already has the authority and powers to investigate and prosecute drug-related money transactions.[225]

Moreover, Pakistan's banking reforms have come at the heels of a political overhaul of the Pakistani government led by General Parvez Musharraf.[226] Musharraf, who orchestrated a bloodless coup in October 1999 against the then Prime Minister Nawaz Sharief,[227] introduced a series of sweeping amendments to the Pakistani Constitution which his government anticipates will lay the groundwork for a "fair and clean[] democracy [in Pakistan] and . . . block corrupt and incapable politicians from participation in . . . election[s]."[228] Whether Musharraf has delivered on his promise of a "fair and clean" democracy in Pakistan is far from decided. However, the impact of Musharraf's government's on the Pakistani economy, which is projected to grow this year at a rate of 4.5 percent is undisputed.[229] Indeed, "fiscal austerity" and political reform measures imposed by Musharraf's government have led to increased tax revenues, low interest rates and a shrinking national debt in Pakistan.[230] Another positive feature with respect to

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223. *See* National Accountability Bureau of Pakistan, *at* http://www.nab.gov.pk/ (last modified Mar. 7, 2005) (last visited Mar. 24 2005). The NAB was established in Pakistan in 1999 pursuant to a Presidential Ordinance calling for a "free, transparent, and across the board accountability" of cases involving "corruption, corrupt practices, misuse/abuse of power, misappropriation of property and kickbacks." *Id.*

224. *See* HUSAIN, *supra* note 211, ¶ 2; *see also Forty Recommendations*, *supra* note 115, at 8. That recommendation stresses that "countries should ensure that designated law enforcement authorities have responsibility for money laundering and terrorist financing investigations." *Id.*

225. HUSAIN, *supra* note 211, ¶ 2.

226. Harold Gould, *Coup in Pakistan – An Expert's Initial Observations*, DEFENSE AND THE NATIONAL INTEREST, Oct. 15, 1999, http://www.d-n-i.net/fcs/comments/c325.htm.

227. To many outside observers the coup against Prime Minister Nawaz Sharief was no surprise as Shareif was widely recognized as incapable of "significantly reducing corruption, improving living standards, or constructively managing political dissent in Pakistan." *Id.*

228. Syed Atiq Ul Hassan, *The Road Map of Democracy in Pakistan*, *at* http://www.totse.com/en/politics/the_world_beyond_the_usa/166079.html (n.d.) (last visited Mar. 24, 2005).

229. John Lancaster, *Finding Opportunities in Post-9/11 Pakistan; Growing Economy Sparks Return of Capital, Expertise*, WASH. POST, Feb. 17, 2003, at A27, *available at* http://www.washingtonpost.com/ac2/wp-dyn?pagename=article&contentId=A18570-2003Feb16&notFound=true.

230. *Id.*

Pakistan's economy is Pakistani rupee's health which "has gained 11% against the greenback since September 11, largely because of a crackdown on the black market *hawala* system of money transfers, as part of the war on terror."[231] As a result, the country's foreign exchange reserves have topped $9.5 billion for the first time, giving the Pakistani rupee unusual strength.[232]

2. *Assessment of Pakistani Legislation*

Contrary to the Indian example, the initial assessment of the Pakistani Government's efforts to regulate *hawala* transactions appears positive.[233] After the implementation of reporting requirements and simultaneous initiatives by the SBP, "thousands of dealers across Pakistan have watched their thriving businesses falter and in some cases collapse."[234] Moreover, since the change in policy official remittances have tripled.[235] Indeed, the SBP has seized the opportunity to increase official remittances and has instituted systems to maintain a database of all remittances and "introduce[ed] a handful of new products" that will ensure delivery of cash quicker.[236]

The reason for Pakistan's success can be attributed to its successful recognition of the policy goals necessary to regulate *hawala* transactions beyond mere licensing of *hawaladars*.[237] Indeed, coupled with Pakistan's licensing requirements were initiatives to improve the SBP banking practices, particularly, allowing the informal market to co-exist with formal banks for a period of time as well as the implementation of successful fiscal austerity measures to improve Pakistan's economic standing.[238] With obvious disincentives for the use of the *hawala* system, expatriate Pakistanis have been

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231. Naween A. Mangi, *Pakistan Turns an Unlikely Corner*, BUSINESS WEEK, Apr. 15, 2002, *at* http://www.businessweek.com/bwdaily/dnflash/apr2002/nf20020415_4345.htm.

232. *Id. See also* Imtiaz Gul, *Boom Time for Pakistani Economy*, ECONOMY NEWS, Sept. 2, 2003, *at* http://english.aljazeera.net/NR/exeres/F5C15088-CB1D-4278-97F7-7C60F33132F5.htm. In 2001, the rupee fell 23% against the U.S. dollar and in the 1990s, foreign investors lost an average of 8% to 10% on their investments every year on account of the depreciation of the rupee; "this year, for the first time, they won't – and this is a very good trigger from them to look at Pakistan." *Id.*

233. *See Pakistan Cripples the Money Movers*, BUSINESS WEEK, Jan. 31, 2002, *at* http://www.businessweek.com/bwdaily/dnflash/jan2002/nf20020131_6995.htm [hereinafter *Pakistan Cripples*].

234. *Id.* Forex Association of Pakistan, a Karachi-based trade group, reports that *hawala* business has been reduced by 75% in Pakistan. *Id.*

235. *Id.* "According to the most recent figures available from the State Bank of Pakistan, monthly remittances [through the formal sector] climbed to 260 million, from an average of 80 million." *Id.* The treasurer of Habib Bank, "Pakistan's second-largest bank, estimates that official remittances will rise from $1.07 billion last year to $2 billion by the end of fiscal 2002. Within the next two to three years . . . they could hit $5 billion." *Id.*

236. *Id.* "Habib-Bank has automated its systems to maintain a database of all remittances and is introducing a handful of new products that will ensure delivery of cash within 24 hours." *Id.*

237. *See supra* discussion Part Two B.

238. *Id.*

routing their remittances through the banking system instead.[239]

However, a more evident difference between the Indian and Pakistani strategy rests in the differing political situations in each country. In Pakistan, "history has shown that military [g]enerals . . . are more skillful and diplomatic" than politicians.[240] Musharraf's government has been able to swiftly and effectively install fiscal precision and political reform measures that have helped reduce the economic incentives for both expatriate and resident Pakistani's to engage in *hawala* in Pakistan.[241] Indeed, contrary to the case in India, where decades of corruption have bred more corruption, destabilizing efforts to reign in *hawala* transactions, Pakistani leaders have taken advantage of the political climate in Pakistan to implement balanced legislation. This has had a marked deterrent effect on Pakistan's economic incentives to engage the *hawala* system.

C. *United Arab Emirates (UAE)*

1. *Hawala in UAE and UAE Response*

The UAE has been described as the third leg in a *hawala* triangle encompassing India and Pakistan.[242] Dubai is regarded as a "key point in the global *hawala* network" due, in part, to the "large presence of expatriate workers and businessmen there."[243] Post-September 11, Western nations, led by the United States, have alleged that chief terror suspects of the Al-Qaeda network "transferred funds through the *hawala* [system] . . . and the United Arab Emirates (UAE) was cited as a transit point from where most of the money spent by the individuals behind the Sept[ember] 11 terror attacks was reportedly transferred."[244] As a consequence, the UAE was placed on FATF's "watch list" in the months following September 11.[245]

Partly in response to international pressure, the UAE Central Bank,[246] in

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239. *See Pakistan Cripples*, *supra* note 233.

240. Ul Hassan, *supra* note 228.

241. *See id.*

242. *See Pakistan Cripples*, *supra* note 233. *Hawala* "is an extensive international money transfer system based around the triangle of Pakistan, Dubai and parts of India." *Id.*

243. Raveenran, *supra* note 105, at 5. In the United Arab Emirates (UAE) *hawala* "often takes the form of flight of capital resulting from exchange controls, regulations against outflow of funds and other policies followed by many Asian countries, including India." *Id.*

244. N. Janardhan, *Hawala System Draws International Attention: Despite Crackdown, Alternative Banking System Thrives*, INTER PRESS SERVICE, June 14, 2002, *at* http://www.cyberdyaryo.com/features/f2002_0614_04.htm.

245. Raveenran, *supra* note 105.

246. *See* The Monetary System and Organization of Banking, No. 10, art. 5 (1980) (U.A.E.). The function of the UAE central bank is laid out in this statute:

> The Bank shall direct the monetary, credit and banking policy and supervise over its implementation in accordance with the State's general policy and in such ways as to help support the national economy and the stability of the currency. For the attainment of its objectives, the Bank shall: (1) exercise the privilege of currency

May 2002, hosted the first international conference on *hawala*.[247] Over three-hundred delegates representing regulatory bodies, law enforcement agencies, supranational institutions, banks, and money changers from nearly forty participating countries gathered in Abu Dhabi to map an effective regulatory strategy for *hawala*.[248] The conference, hosted by the UAE Central Bank National Anti-Money Laundering Committee,[249] culminated in the "Abu Dhabi Declaration" recognizing the need for a regulatory and supervisory system through licensing for *hawala* transactions while simultaneously acknowledging that *hawala*, as a system, "has some positive aspects" that should not be banned.[250] Following the recommendations of the conference, the UAE Central Bank revised its resolutions regarding the regulation of financial and monetary

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> issue in accordance with the provisions of this [1980] Law; (2) endeavor to support the currency, maintain its stability internally and externally, and ensure its free convertibility into foreign currencies; (3) direct credit policy in such ways as to help achieve a steady growth of the national economy; (4) organize and promote banking and supervise over the effectiveness of the banking system according to the provisions of this [1980] Law; (5) undertake the functions of the bank of the Government within the limits prescribed in this Law; (6) advise the government on financial and monetary issues; (7) maintain the U.A.E. Governments reserves of gold and foreign exchange; [and] (8) act as the bank for banks operating in the Country; (9) act as the State's financial agent at the International Monetary Fund . . . .

Id.

247. *Poor Man's Private Banking*, Emirates Bank Group, *at* http://www.emiratesbank.com/ebg/resourcecenter/insights/insights34.htm (May 2002); *see also* CENT. BANK OF THE U.A.E., UNITED ARAB EMIRATES, SECOND INT'L CONFERENCE ON *HAWALA* – CONFERENCE STATEMENT (Apr. 2004). Recently, the UAE hosted the Second International Conference on *hawala* which "acknowledged and reaffirmed the important achievements of the First International Conference on *Hawala*. . . ." *Id.*

248. *Id.*

249. U.A.E. Anti-Money Laundering Law, art. 9 (1995) (U.A.E.). This article provides for the creation of an anti-money laundering committee named The National Anti-Money Laundering Committee which:

> [S]hall be formed under the chairmanship of the Governor of the [UAE] Central Bank, consisting of representatives of the following agents, as per their respective nominations: [a] The Central Bank[;] [b] The Ministry of Interior[;] [c] The Ministry of Justice, Islamic Affairs and Awqaf[;] [d] The Ministry of Finance and Industry[;] [e] The Ministry of Economy and Commerce[;] [f] Municipalities, economic departments or other agencies concerned with issuing trade licenses[;] [g] The UAE Customs Council.

Id.

250. Vimala Vasan, *UAE Looking at Steps to Regulate Hawala Dealings*, BUSINESS LINE, May 29, 2002, *at* http://www.blonnet.com/2002/05/29/stories/2002052900500600.htm; *see also* Anthony E. Wayne, International Dimension of Combating the Financing of Terrorism, Testimony to the House Committee on International Relations, Subcommittee on International Terrorism, Nonproliferation and Human Rights (Mar. 2003), *at* http://www.state.gov/e/eb/rls/rm/2003/19113.htm. The *hawala* system "ha[s] been in operation for years and [is] considered quite a normal transaction in most cases [for people] who earn through legitimate means [such as] blue-collar expatriate workers and other expatriate employees [who] resort to *hawala* due to the low cost charged and faster delivery system it offers." *Id.*

intermediaries.[251] To this end, the "Central Bank had recently issued 61 certificates to *hawala* brokers while another 22 brokers will be registered in the coming period."[252]

The UAE has had formal banking regulations and supervision for non-bank remitters' operators since the 1980s with passage of Union Law No. 10.[253] Subsequent resolutions to the laws permit moneychangers to be licensed as "money remitters."[254] Under the law, "*hawala* operators must record details of persons or institutions that transfer an amount . . . of 2,000 [Dirhams] or [its] equivalent in other currencies."[255] Additionally, the law requires particular documentation to be used by *hawaladars* for customer identification purposes.[256] In transfers of less than 2,000 Dirhams, the transferor should be issued a receipt.[257]

Moreover, in January 2002 the UAE passed an anti-money laundering law imposing restrictions on monetary transfers.[258] The council of Ministers of the UAE approved the UAE Anti-Money Laundering Law, which makes the laundering of property derived from unlawful means a criminal offense. Relevant provisions of this act call for: (1) the creation of a "'financial information unit' to deal with money laundering and suspicious cases;"[259] and

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251. *See* UNITED ARAB EMIRATES CENT. BANK BD. OF DIRS., CENT. BANK OF THE UNITED ARAB EMIRATES, REGARDING THE REGULATION FOR FINANCIAL AND MONETARY INTERMEDIARIES - RESOLUTION NO. 126/6/95 (1995); UNITED ARAB EMIRATES CENT. BANK BD. OF DIRS., CENT. BANK OF THE UNITED ARAB EMIRATES, REGARDING THE REGULATION FOR FINANCIAL AND MONETARY INTERMEDIARIES – RESOLUTION NO. 153/5/97 (1995).

252. *U.A.E. Defends Hawala System*, UAE Interact – The Official Website for the Ministry of Information and Culture of the UAE, *at* http://www.uaeinteract.com/news/default.asp?cntDisplay=10&ID=220 (last visited Apr. 10.2005).

253. *See* The Monetary System and Organization of Banking, No. 10 (1980) (U.A.E.); *see also* QORCHI ET AL., *supra* note 3, at 25.

254. UNITED ARAB EMIRATES CENT. BANK BD. OF DIRS., CENT. BANK OF THE UNITED ARAB EMIRATES, REGARDING REGULATING OF MONEY CHANGING BUSINESS IN THE U.A.E – RESOLUTION NO. 123/7/92, art. 2 (1992) [hereinafter RESOLUTION 123/7/92]. This resolution provides for a licensing requirement in the United Arab Emirates stating that "no person, whether natural or juridical, shall carry on money changing business in the United Arab Emirates unless he is licensed in writing by the Governor of the Central Bank to do so in accordance with this Resolution or unless he is exempted from the provisions thereof." *Id. See also* QORCHI ET AL., *supra* note 3, at 25.

255. QORCHI ET AL., *supra* note 3, at 25; *see also* Resolution 123/7/92, *supra* note 254, art. 4(2); Press Release, Central Bank of the United Arab Emirates, Anti-Money Laundering New Law, *at* http://www.cbuae.gov.ae/Releases/AntiMoneyLaundering2.htm (n.d.) (last visited Oct. 29, 2003). The central bank through a decision of its Board of Directors reduced the thresholds for official identification to 2,000 Dirhams from 200,000 Dirhams for moneychangers. *Id.*

256. QORCHI ET AL., *supra* note 3, at 25. The law requires that the documents listed be used for customer identification: "(1) passport; (2) U.A.E. ID card for U.A.E nationals; (3) labor card for non-U.A.E. nationals; or (4) driver's license." *Id.*

257. *Id.*

258. *Id.*

259. UAE Anti-Money Laundering Law, at art. 7. This article states that:

> [T]here shall be established, within the Central Bank, a unit named the 'financial information unit' to deal with money laundering and suspicious cases, and to

(2) agencies "concerned with licensing and supervision of financial institutions or other financial, commercial and economic establishments" to establish "mechanisms to ensure compliance of those institutions."[260]

2. Assessment of UAE Legislation

The UAE has largely followed Pakistan's strategy of balanced regulation of *hawala* through licensing while also making additional efforts to address weaknesses that may exist in the formal sector.[261] Like Pakistan, the UAE recognized that "[o]ver-regulation or, indeed, making [*hawala*] illegal would not work . . . [i]t would drive the business[es] underground" like the case in India.[262] However, as the UAE, distinct from India and Pakistan, is primarily a *hawala* remitting country, its regulatory approach must have an increased focus on effective law enforcement and improved service quality in order to deter *hawala* transactions at their source.[263]

Unlike the Indian and Pakistani cases, the UAE enjoys a heightened quality of political stability and formal financial sector security, each of which, as has been demonstrated in India and Pakistan, has an important influence on the regulatory attitude toward *hawala*.[264] As the UAE is primarily a *hawala*-remitting country, the regulatory scheme adopted by UAE authorities recognizes this fact, and its supervisory interest stems primarily from concerns

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> which reports of suspicious transaction shall be sent from all financial institutions and other financial, commercial and economic establishments. The committee shall determine the format for reporting suspicious transactions and methods of communicating reports to the said unit. The said unit shall render the information available with it at the disposal of law enforcement agencies to facilitate their investigations. The said unit may exchange information on suspicious transactions with their counterparts in other countries in accordance with international conventions to which the state is party, or on the basis of reciprocity.

Id.

260. U.A.E. Anti-Money Laundering Law, art. 11. This article states that:

> [A]gencies concerned with licensing and supervision of financial institutions or other financial, commercial and economic establishments are required to establish appropriate mechanisms to ensure compliance of those institutions with anti-money laundering rules and regulations in the state. This should include reporting of suspicious cases, upon detection thereof, to the unit stated in Article 6 herein.

Id.

261. *See* Interview by International Herald Tribune with Sultan bin Nasser Al-Suwaidi, the United Arab Emirates Central Bank Governor (Oct.10, 2003).

262. *Id.* Sultan bin Nasser Al-Suwaidi, the UAE Central Bank Governor, recognized the challenge he faced was to:

> [C]reate a system that enabled the many people, particularly foreign workers, who have used the [*h*]*awala* system for legitimate purposes, to continue doing so, while making it as difficult as possible for those who want to abuse the [*h*]*awala* system for illegal purposes.

Id.

263. *See* QORCHI ET AL., *supra* note 3, at 25.

264. *Id.* at 27.

about *hawala*'s potential for abuse.[265] Consequently, the UAE has cooperated with international efforts to prosecute criminal *hawala* operations, in particular with respect to the international effort against Al-Barakaat, a Somali-based *hawala* operation.[266] Al-Barakat had locations in over forty countries and used its *hawala* system to provide "material, financial and logistical support" to terrorist groups through its financial center located in Dubai.[267] The UAE, coordinating with the United States Department of Treasury, was able to successfully block Al-Barakat's assets in Dubai, disrupting the organizations cash flow in excess of sixty-five million dollars.[268] Indeed, the UAE's balanced legislative and enforcement technique worked to successfully undermine the financial power of trafficking networks and organized crime, amplified by the case of Al-Barakat.[269]

CONCLUSION

Hawala transfers provide a cost effective, speedy, reliable, and trustworthy method for remittances. The *hawala* system has survived because of its demonstrated resilience in a banking market that is both competitive and efficient. The mechanics behind a typical *hawala* transfer, consisting of transactions across international lines involving multiple currencies and settlement procedures, do not differ from other remittance systems, the only derogation being *hawala*'s existence in the informal realm. Having legitimate purposes, such as worker remittances, humanitarian relief and personal investment expenditures, *hawala* plays an important role in many nations. However, like any other financial system, *hawala*'s susceptibility to abuse for illegitimate purposes, like smuggling, money laundering, and terrorist financing has drawn serious criticism from the international community.

The Financial Action Task Force, a creation of the Group of Seven Industrialized Nations, has taken the lead in modeling and recommending that countries adopt legislation to regulate informal fund transfers, including *hawala*. FATF's list of Forty Recommendations and subsequent addition of Eight Special Recommendations has served as the benchmark for domestic efforts to regulate the informal banking sector. FATF's active role in identifying, reviewing, and sanctioning non-compliant countries has served as motivation for nations to adopt FATF style policies based on licensing of individuals engaged in the informal business transactions. However, FATF recommendations fail to account for several economic incentives inherent in the *hawala* system. A detailed study of India, Pakistan, and the UAE reveals the

265. *Id.* at 27.

266. Press Release, Statement of Jimmy Gurule, Under Secretary for Enforcement U.S. Department of the Treasury Before the Commission on Security and Cooperation in Europe (May 8, 2002) (transcript available with author).

267. *Id.*

268. *Id.*

269. *Id.*

importance of a country's economic and political environment in reigning in the *hawala* system.

India's strict approach to regulating its informal economy, amounting to an all-out ban on *hawala*, had poor results. Due, in part, to India's corrupt democratic system, India's legislative efforts to curb *hawala* transactions have largely been underscored, despite its attempts to implement many FATF recommendations. This result can be explained by deficiencies in FATF's recommendations that fail to account for political reforms necessary in many *hawala* remitting and receiving countries. Conversely, more recent efforts by Pakistan and the UAE have seemingly accounted for the Indian mistake of over regulation and have attempted to reign in *hawala* transactions through gradual licensing requirements coupled with financial and political sector reforms, offering competitive remittance alternatives to *hawala*. In Pakistan, for instance, efforts to regulate *hawala* took shape after a political overhaul of the Pakistani government. Additionally, successful cooperative efforts to reign in criminal *hawala* enterprises based in the UAE highlight the important role *hawala* remitting countries play in the *hawala* regulatory effort.

Given these considerations, countries seeking to regulate their *hawala* markets would serve themselves well by examining India, Pakistan and the UAE as examples of both effective and ineffective polices and legislation. Pakistan and the UAE have recognized the inherent economic incentives to engage in *hawala* and have taken advantage of their domestic political climates to implement balanced legislative and political reforms that recognize and respond to these incentives. Other net *hawala* remitting and receiving countries should follow suit and implement similar balanced economic and political responses.