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# **An evaluation of reforms to auditor liability: a necessity or a step too far?**

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## Abstract

*Auditors provide a key investigative function in the business world. The law in relation to auditors changed significantly with the introduction of the Companies Act 2006 and it is now possible for audit firms to limit their liability towards clients through contractual agreements. Such an opportunity for limitation has proven to be controversial, and this article will assess whether this step was really necessary by considering the current potential for liability of auditors, evaluating the existing restrictions on liability, and whether further limitations were even required.*

*It will be argued that, as since the law on negligence is already quite restrictive, particularly in relation to third parties, if auditors are vigilant and aware of the potential for mistakes and dishonesty, liability is unlikely to arise. It will further be contended that in light of the limitations which already existed in existence, there was no real need for additional limitation in this area. The true value of these agreements will be disputed, particularly as there appears to be low uptake and significant restrictions in relation to US stock exchange listing, meaning that listings; not one of the four largest accountancy firms has entered into such an agreement with their its FTSE 350 clients.*

## A. Introduction

The crusade of the accountancy world to reduce their liability has been long fought for and much commented upon. Throughout the 1990s increasing litigation led to the view that many auditors were being unfairly pursued which resulted in a 'deep pocket syndrome'<sup>1</sup> where claims would be targeted against auditors for an amount which was not proportionate to their blame simply because they had the greatest resources with which to compensate the claimant. In addition to transnational claims, this was mainly on account of the changing nature of the claimant moving from law firms, who were reliant on 'repeat interactions' with auditors, to a new type of claimant who was "only interested in a 'one shot game.'<sup>2</sup> These plaintiffs are likely to be liquidators, whose only remit is to recoup the maximum amount possible for the creditors of an insolvent company; unlike law firms, they have no vested interest in keeping accountants stable.

The damaging culmination of these effects was revealed in the catastrophic collapse of Arthur Andersen in 2002 following the Enron scandal, thus reducing the Big Five to the Big Four<sup>3</sup> and wiping out one of the few remaining players on the audit scene capable of auditing the largest multinationals.<sup>4</sup> The Enron scandal is much bandied around by those in favour of reform as a strong example of exactly why limits to auditor liability are required, mainly because of the economic and political shock associated with the scandal. However, this case and the resulting collapse of Arthur Andersen had little to do with the auditors' liability. In the aftermath of the demise of Enron, Arthur Andersen was accused of criminal conduct. This resulted in a severe loss of reputation and clients fled as confidence declined.<sup>5</sup>

Furthermore, it should be made clear that the pursuance of Arthur Andersen was an American case. Using this as evidence to suggest that further limitation is required in England and Wales, in order to avoid a large-scale collapse, is to perhaps stretch its relevance too far. As is proposed in section B, the law on negligence in this jurisdiction is already quite restrictive; further limitations and safeguards, such as Limited Liability Partnership (LLP) status and insurance possibilities, already exist. To cite Arthur Andersen in this context ignores both these points. Tort law in the US is based on comparable principles, but one should be careful not

<sup>1</sup> Directorate General for Internal Market and Services, 'Consultation on Auditors' Liability' (Summary Report) 2, para 6.

<sup>2</sup> London Economics, *Study on the impact of Auditors' Liability Regimes* (2006) 81.

<sup>3</sup> Refers to the four largest accountancy firms: Ernst & Young, KPMG, PriceWaterhouseCoopers and Deloitte Touche Tohmatsu.

<sup>4</sup> Hannigan, *Company Law*, (2<sup>nd</sup> Ed., OUP 2009) 408.

<sup>5</sup> Flores, 'New trends in auditor liability' (2011) 12(3) E.B.O.R 415, 427.



to rely on Arthur Andersen as the main basis of the argument for greater limitation of liability. Furthermore, to do this makes, 'no clear distinction...between the risks to which auditors are exposed in the US, where class actions are common, and those in Europe where this legal concept does not exist in the same way.'<sup>6</sup> It is proposed, therefore, that the collapse of Arthur Andersen is not suitable evidence to support the auditors' argument that further limitation on liability was required to prevent a collapse. Not only does it involve American legal principles, but it was not the sole factor: the loss of reputation following criminal investigation that was the final nail in Arthur Andersen's coffin and not the size of a claim brought against them for negligence in a civil suit.

Yet it would be unwise to dismiss the consequences a collapse of such a firm could have on the industry as a whole. Key to this is the distinction between 'linchpin' firms, those critical to the survival of the audit network (in particular the Big Four), and 'non-key' firms.<sup>7</sup> The demise of a 'non-key' firm will not, 'result in widespread disruption,' for the capital markets in general.<sup>8</sup> Conversely, the collapse of a 'linchpin' firm could, 'imperil the whole market and thus have wider repercussions for capital markets.'<sup>9</sup> A London Economics study points to the threshold of a claim, above which a firm could no longer survive; based on the 2005 income figures, this would range between €170 million and €365 million.<sup>10</sup> When it is considered that in 2009 PwC faced a claim of \$2bn (£1.2bn) in relation to Bernard Madoff's investment fraud,<sup>11</sup> it is obvious that the success of such a claim would most certainly mean the end of any one of the Big Four and could have dire results for capital markets by leaving clients struggling to find firms large enough to cover both their accountancy and auditing needs.

While these figures may seem ominous, many firms have actually chosen to settle out of court and for significantly less than the original claim.<sup>12</sup> It is difficult to find precise figures in this area as firms usually try to prevent the amounts they have paid out from becoming public knowledge. That being said, it has been proposed that many plaintiffs bring such large claims in order to force the defendant's hand into settling. This means that the claimants of a company, usually insolvent in most cases, do not have to finance the costs of a lengthy legal battle and the defendant can avoid any unnecessary negative publicity and the potential burden of a catastrophic claim. However, this view of the potential impact of large claims ignores the swift adaptation of the audit and capital markets to the collapse of Arthur Andersen.<sup>13</sup> It is therefore questionable whether the market has sufficient resources to adapt to the closure of another large firm; safeguarding the Big Four was thus central to the reforms regarding auditor liability.

As noted previously, audit firms are incredibly risk aware. Stringent risk management regimes are central in any audit and some firms have refused to audit certain high-risk clients. London Economics reported that, 'potential liability risk is the main reason for declining to take on an audit engagement or resigning from such an engagement.'<sup>14</sup> However, they later noted that a cap does not appear to have, 'a marked effect on resignations and declines.'<sup>15</sup> It had been suggested that because potential liability was so great, auditors were dissuaded from taking on the largest clients because the risks, as they believed, were insurmountable. This in turn would have a negative impact on the capital markets, as large companies with large risks would find it difficult to locate an auditor willing to audit them. However, this result shows the lack of basis to the claim

6 *ibid.*

7 London Economics (n 2) 104.

8 *ibid.*

9 *ibid.*

10 *ibid* 105.

11 Sean Farrell, 'Billion-dollar lawsuit could destroy top accountancy firms' *The Telegraph* (London, 29 August 2009) < <http://www.telegraph.co.uk/finance/newsbysector/supportservices/6111149/Billion-dollar-lawsuit-could-destroy-top-accountancy-firms.html> > accessed 21 February 2012.

12 Flores (n 5) 422.

13 Eric L. Talley, "Cataclysmic Liability Risk among Big Four Auditors" [2006] 106 CLR 1641, 1645.

14 London Economics (n 2) 167.

15 *ibid* 168.





that a limitation on liability would increase the availability of audit choice for large businesses as the figures for declines and resignations are approximately the same whether liability is limited or not.

Additionally, accountancy firms place a high value on the audit market. Not only does the industry have a captive audience due to statutory requirements, there is also a very large indirect value, as many firms use their audit services as a “loss leader” to gain access to the largest firms and provide them with other, more lucrative, financial services.<sup>16</sup> It seems unlikely, consequently, that audit firms would be willing to withdraw this service as there is potential for greater and longer-term revenue following the provision of other services.<sup>17</sup>

The audit profession's case for limited liability is therefore somewhat flawed. Although there is the potential for a large claim to be brought against a firm, it appears that within the current law of negligence (see section B), there is a fairly common sense approach towards liability and it would be unlikely for a claim to succeed, unless the auditor had been particularly careless. Furthermore, even if a claim is brought, out of court settlements for a much lower amount are the norm and even if the claim does come under judicial adjudication, judges are likely to consider all the surrounding circumstances when deciding on a suitable amount. In addition, whilst it appears that the availability of insurance will always remain a difficulty, the potential collapse of another one of the Big Four, and further concentration of the audit market, seems unlikely. The nature of a claim, and the resulting implications for reputation, are more important for the survival of a firm than the size of the claim.

One should not disregard the sheer size of the Big Four and their capacity for intense lobbying, which they undertook during the drafting process. In 2004, the OFT had rejected the auditors' arguments in relation to increased competition and the lack of evidence of courts making excessive awards for damages.<sup>18</sup> In 2005, following public and industry consultations, the DTI rejected the idea of a predetermined cap on liability, but were nevertheless, ‘persuaded of the benefits of change.’<sup>19</sup> Whilst it is not suggested that the Big Four dictated the terms they desired, it is obvious that this lobbying had some effect, which resulted in the Government changing its position by introducing an opportunity for firms to contractually limit their liability.

Key emphasis was placed by the Government on the need for specific safeguards on audit quality if the proposition to limit liability were to go ahead.<sup>20</sup> The possible impact of Liability Limitation Agreements (LLAs) on audit quality will be discussed in more detail later, but nonetheless it seems the Government was already aware at this early stage of the adverse consequences to audit standards that could arise if this level of protection was afforded to the audit industry. However, as was noted earlier, audit firms already have stringent quality processes in place, as well as external supervision from professional bodies, to limit the potential for liability to arise and to protect their reputation within the audit market.

## **B. Establishing Liability**

If an auditor has conducted an audit in a negligent manner, he can either be liable in tort or through his contractual duty with the company being audited, or both. Most discussion has centred on how far the auditor's duty in tort extends to third parties. The courts have been reluctant to place too onerous a task on the audit profession and, ‘the auditor is not a guarantor.’<sup>21</sup> Company members and other third parties are not entitled

<sup>16</sup> Office of Fair Trading, *An Assessment of the Implications for Competition of a Cap on Auditors' Liability* (London: OFT, July 2004) paras 4.25-4.27.

<sup>17</sup> *ibid* para 4.28.

<sup>18</sup> *ibid* paras 1.2-1.4.

<sup>19</sup> Department of Trade and Industry, *Company Law Reform*, (Cm 6456, 2005) 25.

<sup>20</sup> *ibid*.

<sup>21</sup> Davies, Gower & Davies: *Principles of Modern Company Law*, (8<sup>th</sup> edn, Sweet & Maxwell 2008) 798.



to rely on the auditor's verification and therefore the law should not present auditors with too high a standard to meet when assessing liability. Overall, an auditor can be liable either in contractual, tortious or criminal circumstances; each of these areas will be discussed in turn.

### I) *Contractual Liability*

There is usually a contract that exists between the audit company and its client which gives rise to a contractual relationship and its surrounding duties. If an auditor does not exercise reasonable care and skill, the client company will be able to claim for damages for any loss arising from the situation. The auditor's implied contractual duty of care is owed to the company and not to individual members as the contract is formed with the company as a separate legal person.<sup>22</sup>

Lindley LJ has asserted that the auditor's role is to, 'ascertain and state the true financial position of the company at the time of the audit, and his duty is confined to that.'<sup>23</sup> However, merely checking the accounts does not fully discharge the duty. There must be some form of enquiry, but that will depend upon the circumstances of the individual case; if there is, 'nothing to excite suspicion,'<sup>24</sup> then it is sufficient that the auditor makes very little enquiry.

This approach is perhaps now a little too generous in its expectation of the auditor. Lord Denning stated that the auditor should undertake his task with, 'an inquiring mind-not suspicious of dishonesty.'<sup>25</sup> This view seems to propose that even where his suspicion is not aroused, the auditor should at least carry out basic checks to ensure that no mistakes have been made. It could also be suggested that, whilst the auditor should not necessarily be, 'suspicious of dishonesty,' there is some expectation that he may have to make enquiries into not only mistakes, but also potential dishonesty. Put simply, the auditor should not close his mind to the possible extent of his duty and should be open to pursuing every avenue, particularly, but not confined to, those where his suspicions are raised. The international standards set by the Auditing Practice Board, which state that, 'an attitude of professional skepticism,'<sup>26</sup> should be adopted, as well as those outlined by the Accounting Standards Board, provide guidelines for the profession; although not legally binding, these could be used as strong evidence for a breach of the auditor's duty, if they, 'rely blindly on the information provided to them,'<sup>27</sup> and do not think to investigate properly.

### II) *Tortious Liability and Claims by third parties*

The route for third parties to recover any loss that may have been incurred from a negligent audit lies in tort.

Hedley Byrne<sup>28</sup> first established the principle that the law of negligence could be extended to include a common law duty of care relating to economic loss arising from negligent misstatement and created tortious liability where there was no previous contractual relationship.<sup>29</sup> The case itself did not concern an audit and it was not until the decision in Caparo<sup>30</sup> that it was made clear when this duty would arise in relation to auditors; the extension of the duty of care to potential investors was rejected in this case.<sup>31</sup>

22 *Equitable Life Assurance v Ernst & Young* [2004] P.N.L.R. 16 [95].

23 *Re London and General Bank (No2)* [1895] 2. Ch 673, 682.

24 *ibid* 683 (Lindley LJ).

25 *Fomento (Sterling Area) Ltd v Selsdon Fountain Pen Co Ltd* [1958] 1 W.L.R. 45, 61.

26 Auditing Practices Board, *International Standard on Auditing: Objective and General Principles Governing An Audit of Financial Statements* (London: APB, Jan 2006) para.6.

27 Lee Roach, 'Auditor Liability: the case for limitation: Part 1' (2010) 31(5) Comp. Law. 136, 139.

28 *Hedley Byrne & Co Ltd v Heller & Partners Ltd* [1964] A.C. 465.

29 *ibid* 502.

30 *Caparo Industries plc v Dickman* [1990] 2 A.C. 605.

31 *ibid* 662 (Lord Jauncey).





The three-fold test outlined in Caparo is as follows:

- 1) There should be a relationship of 'proximity' between the parties.<sup>32</sup>
- 2) The resulting damage is reasonably foreseeable.<sup>33</sup>
- 3) 'The situation should be one in which the court considers it fair, just and reasonable that the law should impose a duty of a given scope.'<sup>34</sup>

This is not an easy test to meet. Firstly, a third party must establish that the defendant auditor owed him a duty of care. This requires a 'special relationship.'<sup>35</sup> In order to help define this concept, Lord Oliver outlined four further conditions that he believed the claimant would have to show were present in order to establish sufficient proximity with the defendant party:<sup>36</sup>

- i. *The advice is required for a purpose, whether particularly specified or generally described, which is made known, either actually or inferentially, to the adviser at the time the advice is given;*
- ii. *The adviser knows, either actually or inferentially, that his advice will be communicated to the advisee, either specifically or as a member of an ascertainable class, in order that it should be used by the advisee for that purpose;*
- iii. *It is known, either actually or inferentially, that the advice was so communicated is likely to be acted upon by the advisee for that purpose without independent inquiry; and*
- iv. *It is so acted upon by the advisee to his detriment.*

The relationship of proximity is thus difficult to define and its existence as such must be assessed on the circumstances of each case, thus further increasing the difficulty the claimant faces in trying to meet this test.

Secondly, once the claimant has established that the auditor did have a duty of care towards him, he will then need to show that this duty has been breached. Roach points to the dicta of Lord Diplock in Saif Ali to support his suggestion that the standards required of an auditor are not particularly high,<sup>37</sup> and only if the error was one that, 'no reasonably well-informed and competent member of that profession could have made,'<sup>38</sup> could the duty in question have been breached. It is even less likely that a breach will be found if the auditor has complied with industry practice.

Thirdly, the claimant must establish a dominant causal link between the breach and the loss. From both Galoo<sup>39</sup> and Johnson v Gore Wood,<sup>40</sup> the common sense approach adopted by the judiciary is evident, and in fact, the latter case even goes so far as to express causation more in terms of the duty of care, focussing on the facts of the case as a determining factor.

Even if the claimant can meet these high hurdles and establish that the auditor owed him a duty of care and that the damage was reasonably foreseeable, the court may still hold that it would not be just and reasonable to impose liability. The likelihood, therefore, of a third party claimant succeeding in their action is actually quite remote, unless the auditors have been exceptionally careless in exercising their duty and the court does not use its discretion.

<sup>32</sup> *ibid* 617-618 (Lord Bridge).

<sup>33</sup> *ibid*.

<sup>34</sup> *ibid* 618.

<sup>35</sup> Roach (n 27) 139.

<sup>36</sup> *Caparo* (n 30) 638 (Lord Oliver).

<sup>37</sup> Roach (n 27) 139.

<sup>38</sup> *Saif Ali v Sydney Mitchell* [1980] A.C. HL 198, 220.

<sup>39</sup> *Galoo Ltd v Bright Grahame Murray* [1994] 2 BCLC 492.

<sup>40</sup> [2003] All ER (D) 58 (Dec).



Another obstacle to claimants is the decision in *Stone & Rolls v Moore Stephens*<sup>41</sup>, where the auditors failed to spot that the 'directing mind and will' of the firm was in fact defrauding the company. The defendant audit firm was allowed to rely on the defence of *ex turpi causa*. The reasons behind allowing this defence were based mainly on common sense and policy considerations. However, its scope is limited in that it only applies to one-man companies, and it will not therefore provide much deterrence to general claimants as audit firms will not be entitled to rely on such a defence where the audit is of a much larger company with many directors and shareholders making the decisions.

### III) *Criminal Liability*

The Companies Act 2006 (CA 2006) introduces a criminal offence where a person:

(K)nowingly or recklessly causes a report under section 495 (auditor's report on company's annual accounts) to include any matter that is misleading, false or deceptive in a material particular.<sup>42</sup>

The reasons behind this addition are seen mainly in the need to counter-balance the loss of the deterrent effect of unlimited liability for negligent auditing, caused by the introduction of LLAs.<sup>43</sup>

This may have been the goal, but there are a number of limitations to this section. Firstly, the scope of this liability is narrower than in private law as it is limited to intentional or negligent misstatements. Further to this, liability is not extended to cover intentional or reckless misstatements on the directors' report or the section that is auditable on the directors' remuneration report. Here, therefore, criminal liability is more narrowly defined for auditors than for directors,<sup>44</sup> and questions have therefore been raised as to the practical relevance of this section.

Secondly, there is the problem of establishing what types of conduct or omissions may give rise to recklessness and therefore criminal liability. Situations where criminal liability might arise through recklessness include where an auditor may know, 'that there is a problem with a company's accounts and is unwilling to qualify the accounts',<sup>45</sup> or where he, 'suspects that if he looked more closely at a particular area of a company's books he would discover a problem, and therefore decides not to go further into that area.'<sup>46</sup> On the other hand, if an auditor merely has some doubts, and after considering the standard practice of his firm and in his professional judgement decides not to pursue his investigations believing there is no real risk, then, 'he may well be guilty of bad judgement but would not be reckless.'<sup>47</sup>

Government guidance to prosecutors suggests that enforcement of this section through the courts will be low.<sup>48</sup> Indeed, it appears that there have been no prosecutions in relation to s.507 in England and Wales since the introduction of the offence.<sup>49</sup> These provisions will most likely have little impact on the day-to-day working practices of the majority of firms and the consequences flowing from such a conviction will pose little threat. As this section is restricted in its reach and, as will be discussed later, the opportunities available to auditors under the LLA regime to limit civil liability are potentially very wide, a gap in public protection

41 [2009] UKHL 39.

42 Companies Act ("CA") 2006, s 507.

43 For further description see Davies (n 20) 802.

44 CA 2006, ss 414(4), 419(3) and 422(2).

45 HL Deb 14 March 2006, vol 679, col 408 (Lord Sainsbury).

46 *ibid*.

47 Matthew Lawson, 'Auditors can be reckless too' (2008) 23(4) B.J.I.B & F.L. 183.

48 Department for Business Innovation and Skills, *Guidance for Regulatory and Prosecuting Authorities in England, Wales and Northern Ireland: Offences in Connection with Auditors' Reports (Section 507)*, (London, 2010), para 8.

49 A general internet search as well as searches on Westlaw and LexisLibrary produced no results.



could now exist.

#### IV) *Conclusion*

The law therefore takes a sensible approach in deciding whether liability should be imposed on auditors. While the standards required in relation to contractual liability are increasing, if an auditor is methodical and meticulous in his investigations it seems unlikely that the courts would be willing to find him liable. The possibility of a third party being successful in a claim against the negligent auditor in tort is unlikely as the hurdles they would have to overcome, chiefly when establishing a sufficiently proximate relationship with the audit firm, are very high.

The real issue lies in the possibility of joint and several liability, where a claimant can choose to pursue one party for the sum of all his losses in a situation where many defendants may be liable. Auditors argue that they are often sued unfairly or for an unfair amount proportionally to their contribution to the claimant's loss, because they have much 'deeper pockets'<sup>50</sup> than other potential defendants, usually directors. As will be considered later, it is argued by the accountancy profession that this could result eventually in the collapse of an accountancy firm, leading to insufficient audit capacity, which could have devastating effects on capital markets.

Criminal liability also does not appear to pose too great a threat to auditors as the scope of the relevant section is rather narrow and the prosecution rate under s.507 appears to be, if not non-existent, very low in reality.

Audit firms also receive considerable amounts of guidance from professional bodies and regularly invest in implementing internal risk management and audit review programmes. Providing auditors follow all this advice and meet the objective industry standards, it seems unlikely they would then be held liable for negligent auditing. Furthermore, there would be little public interest in pursuing a firm who has been diligent in their work and prudent in managing their quality standards. The risk assessment standards that are set by firms do not necessarily mean auditors are scared of potential liability, but are taking precautionary measures and also ensuring that their reputation remains intact, which from informal discussions, appears to be a major consideration for firms.

#### C. **Ways in which Auditor Liability is limited in England and Wales**

There were a number of methods through which accountancy firms could limit their liability prior to the introduction of LLAs.

##### I) *Limited Liability Partnership (LLP) Status*

Firms could incorporate their business to benefit from limited liability, or register as LLPs in accordance with the Limited Liability Partnerships Act 2000. Prior to the 2000 Act, joint and several liability existed among partners and in the absence of limited liability in a partnership, the personal assets of both the negligent partner and the other partners, could be used to meet a claim.<sup>51</sup> Although now used by a number of professions, the campaign to introduce this status was actually spearheaded by accountancy firms as a reaction to the increase in litigation against them.<sup>52</sup> All of the Big Four undertook LLP status as soon as possible, but it has been argued that this protection is, 'far from perfect.'<sup>53</sup> The limits of LLP status clearly lie in the ex-

<sup>50</sup> Davies (n 21) 795.

<sup>51</sup> Partnership Act 1890, s 12.

<sup>52</sup> V Finch and J Freedman, 'The limited liability partnership: pick and mix or mix-up?' [2002] JBL 475, 495.

<sup>53</sup> Roach (n 27) 138.



tent of a partner's individual financial interest and any further voluntary contribution they may have agreed to; the firm is afforded no protection from collapse in the event of a catastrophic claim as LLP status only ensures that the individual auditors in the partnership are not pursued personally, rather than limiting the liability of the firm as a whole. In fact, there is the possibility that the courts, 'might be led to adopt a more expansive view of negligence liability where LLP status is adopted.'<sup>54</sup> In other words, firms could face larger claims as judges would be less likely to restrict them if the partners are already protected from personal liability.

It will be argued throughout this article that the possibility of a catastrophic claim against an accountancy firm is, in fact remote. The adoption of LLP status clearly offers partners much greater protection and the argument still stands that this is yet another way for the firms to restrict liability, albeit to the extent of individual contributions to the partnership. In light of the restrictive view the law takes, outlined in section B, combined with the other methods at the firms' disposal discussed below, the question stills stands as to whether the 2006 reforms to auditor liability really were necessary.

## II) *Insurance*

Professional indemnity insurance is a requirement for all members of the Institute of Chartered Accountants in England and Wales (ICAEW) and consequently, the Big Four have to carry it. While there is clearly an issue of cost to firms, due mainly to the rising number claims against them in recent years,<sup>55</sup> it appears that they are most worried about, 'the availability of cover rather than cost,'<sup>56</sup> as, 'there are some very large gaps in the coverage.'<sup>57</sup> The increase in both the number and size of claims against auditors has resulted in ineffective insurance provisions. If the insurer provided sufficient insurance coverage, they would expose themselves to the liability instead, the decision in the case of a large claim could therefore ultimately come down to a choice between the potential collapse of one of the Big Four or the collapse of the firm who insures them. It is no wonder then that many insurers are unwilling to take such a risk.

Owing to these factors, many firms rely on 'captive' insurance companies, a trend which increased in the 1990s following the collapse of some commercial insurers.<sup>58</sup> A 'captive' insurance company is a form of self-insurance in which the risks of a parent company of a network are insured through a wholly owned subsidiary or subsidiaries, usually through a common fund. Therefore there are extreme limitations in that the insurance capacity available is confined to the capital of the parent. The reinsurance of captives is incredibly restricted and cover can be, 'less than 5% of some of the mega-claims.'<sup>59</sup> With recent claims against accountancy firms reaching into the billions,<sup>60</sup> the availability of commercial insurance (around \$340 million in 1998<sup>61</sup>) combined with the coverage offered by captives is worryingly insufficient.

Lack of insurance was a key line of argument in both lobbying for LLP status and during the drafting process of the CA 2006, but is the situation actually as dire as it seems? Lord Hoffmann in *Morgan Crucible*<sup>62</sup> recognised that it is difficult to acquire sufficient insurance and in these situations the courts should not be too quick to impose liability. He did seem to suggest that the ability to limit personal liability is central to

54 Finch and Freedman (n 52) 495.

55 Roach (n 27) 137.

56 V Finch and J Freedman, 'Limited liability partnerships: have accountants sewn up the "deep pockets" debate?' [1997] JBL 387, 396.

57 Mozier and Hansford-Smith, 'UK Auditor Liability: An uninsurable risk?' (1998) 2(3) IJA 197, 209

58 Roach (n 27) 137.

59 London Economics (n 2) 99.

60 Patrick Collinson, 'Equitable claims £2.6bn from auditor' The Guardian (London, 16 April 2002) < <http://www.guardian.co.uk/money/2002/apr/16/equitabliflife.uknews?INTCMP=ILCNETTXT3487> > accessed 18 February 2012.

61 London Economics (n 2) 99.

62 *Morgan Crucible Co plc v Hill Samuel & Co Ltd & Others* [1990] B.C.C. 686, 690.



this argument,<sup>63</sup> and therefore it would now be unclear, following the introduction of LLP status, if courts would be less lenient in their decisions. Still, insufficient insurance provision is likely to be a consideration for the court when delivering its judgement.

### ***III) Judicial Protection***

As demonstrated above, courts play a significant role in protecting accountancy firms from large claims. Judges do have, and often exercise, their discretion to reduce liability to a fair amount and do take into account circumstances which may have a negative or an unfair impact on an individual, a firm, or even the profession in general (such as a potential collapse of one of the Big Four). In *Barings*<sup>64</sup>, Evans Lombe J found that, in spite of evidence that a deduction in light of contributory negligence had never reached even 50 per cent in previous case law, deductions here could be made up to 80 per cent.<sup>65</sup> Reducing liability to a fifth of what it potentially could have been shows the power the courts have and use in determining a reasonable amount of liability.

Auditors are also entitled to apply for relief from the court under s.1157 which states that an officer or employee of a company can be excused from liability either wholly or in part, where, 'he acted honestly and reasonably, and that having regard to all the circumstances of the case (including those connected with his appointment) he ought fairly to be excused.'<sup>66</sup> Deciding whether the employee or officer has acted honestly requires a subjective test and whether he has acted reasonably requires an objective test; the court can then exercise their discretion having, 'regard to all the circumstances of the case.'<sup>67</sup>

Roach suggests that if the principles of contributory negligence, scope of duty, causation and court relief were properly engaged by the judiciary, there would be no need for a statutory limitation.<sup>68</sup> This is a sound proposition; it is not necessary to create further limitations and complications to deal with a problem that the courts are already combating effectively.

## **D. Permission of LLAs**

### ***I) Legal Framework of LLAs***

The CA 2006 introduced the possibility for auditors to limit their liability for negligent auditing by contract,<sup>69</sup> and is an exception to the general prohibition on provisions limiting auditor liability in s.532,<sup>70</sup> retained from the Companies Act 1985.<sup>71</sup> There are also a number of safeguards contained in the provision. To begin, s.536 (1) states that for public companies, the LLA must be authorised through an ordinary resolution at a general meeting, but for private companies it is possible to use a written resolution. The agreement can also be terminated by ordinary resolution.<sup>72</sup> The agreement is limited to one financial year<sup>73</sup> and only to an amount that is, 'fair and reasonable in all the circumstances.'<sup>74</sup> Disclosure of the LLA may be required to be

<sup>63</sup> *ibid*.

<sup>64</sup> *Barings Plc and another v Coopers & Lybrand and others* [2003] EWHC 1319 (Ch).

<sup>65</sup> *ibid* paras 953, 1069.

<sup>66</sup> CA 2006, s 1157 (1).

<sup>67</sup> *Ultraframe (UK) Ltd v Fielding* [2005] EWHC 1638 [1451].

<sup>68</sup> Roach (n 27) 138.

<sup>69</sup> CA 2006, s 534(1).

<sup>70</sup> *ibid*, s 534(2).

<sup>71</sup> Companies Act 1985 s 310.

<sup>72</sup> CA 2006, s 536(5).

<sup>73</sup> *ibid*, s 535(1)(a).

<sup>74</sup> *ibid*, s 537(1).





entered onto the company's annual accounts.<sup>75</sup> Furthermore, the Secretary of State has the power to either require or prohibit certain provisions or provisions of a certain description specified in the Regulations.<sup>76</sup> There is no specified form that an LLA has to take, and liability can be limited to a sum of money, a proportion of the audit fees, or any other form the parties choose to implement.<sup>77</sup>

## *II) Assessment of LLAs*

This section will assess the impact of LLAs by considering the purposes for which they were introduced, whether these have been met, and also the difficulties faced when contemplating their use and interpretation.

### Deep Pocket Syndrome

The main purpose of the LLA was to relieve audit firms from the burden of indeterminate claims due to joint and several liability (see section A above). By agreeing to limit its liability, a firm is protecting itself from being made liable for more than it has agreed. This means that liquidators, for example, cannot unfairly pursue an audit firm for the full amount of a claim, where their contribution to the loss may only be minimal.

The counter argument is that through the other liability limiting measures available to them, the role of the courts, and the trend of settling out of court, audit firms were already able to reduce their liability sufficiently. Moreover, if claimants are no longer able to go after auditors for the full amount, they may now turn to pursuing directors, even though their pockets are shallower and certainly less well equipped to deal with the amounts of such claims. Of course, this could be a more desirable situation, as it may apportion blame better between the potential defendants.

### Competition

It is believed that the opportunity to limit liability will have pro-competitive consequences in this highly concentrated market. LLAs could encourage middle-tier firms to pursue larger clients as they will be able to limit their liability to an effective amount. Barriers to entry should fall as liability is diminished. Additionally, firms should find it easier to source insurance as their liability risk becomes more predictable and middle-tier firms will be better placed to tender for audit contracts.

LLAs could, however, have adverse effects for competition. The OFT rejected the above analysis as they believed that unlimited liability was only a, 'minor entry barrier.'<sup>78</sup> Other factors such as, 'reputation, third party perceptions, economies of scale, global networks and regulation,' would mean that having the ability to cap liability was unlikely to have much impact on competition.<sup>79</sup> Furthermore, a London Economics Study suggested that reputation was the 'key driver' in the eyes of the middle-tier.<sup>80</sup> LLAs have the potential to significantly lower the price of the audit for clients but, it is unlikely to do anything for reputation, and, as noted above, may in fact have a negative impact on reputation as clients believe that with reduced liability comes reduced quality. Putting these issues aside, middle-tier firms simply do not have sufficient global reach and resources to audit the largest multi-nationals and therefore, in spite of liability reforms, will still be unable to compete with the 'oligopolistic dominance' of the Big Four.<sup>81</sup>

<sup>75</sup> The Companies (Disclosure of Auditor Remuneration and Liability Limitation Agreements) Regulations 2008, SI 2008/489 reg 8.

<sup>76</sup> CA 2006, s 535(2).

<sup>77</sup> *ibid*, s 535(4).

<sup>78</sup> OFT (n 16) para 4.1.

<sup>79</sup> *ibid*.

<sup>80</sup> London Economics (n 2) 35.

<sup>81</sup> OFT (n 16) para 4.6.





Are LLAs only positive for the Big Four? They will be able to offer high rates of liability at relatively low cost, whereas the smaller firms will not have the resources to accept such risks. This could also encourage the Big Four to continue to use audit services as a loss leader to gain other financial service contracts, further affecting the competitiveness of the smaller firms, not only in the area of auditing, but also regarding provision of other financial services. On the other hand, partners will be more willing to provide funding to expand into the audit market, something they would not be likely to consider whilst extortionate liability risks exists, leading to longer term positive effects for competition.<sup>82</sup>

There are therefore positive and negative effects on competition. Of course, to protect the Big Four as intended, the reforms would naturally have to advantage them. In the case of another collapse, the mid-tier firms may now be better mobilised to take on the failed firm's clients, as the liability risks of auditing larger businesses could be reduced to an appropriate amount; a limitation will not facilitate entry by itself, but could aid firms willing to make the transition to the big league.

### Interpretational Difficulties

The Financial Reporting Council (FRC) believes that the, 'key principle in the legislation,' is the ability of the courts to overrule an agreement and reassess liability to an amount which is 'fair and reasonable.'<sup>83</sup> The Act does provide some guidance as to what is meant by 'fair and reasonable' and s.537(1) makes it clear that the circumstances of the case will be considered, having particular regard to the auditor's responsibilities, the nature and purpose of his contractual obligations to the company and the professional standards expected of him.<sup>84</sup>

Roach regards these factors as 'extremely generic.'<sup>85</sup> Nevertheless, I would propose that these points actually provide the courts with a very good starting point, focussing not only an auditor's statutory responsibilities, but also the industry's objective standard; when decisions are made on an individual basis, flexibility is a necessity. Roach seems to suggest that this section would be unfairly advantageous towards auditors as the agreement will still be valid but the amount will merely be readjusted in favour of the auditors. However, the imposition of liability is never advantageous for an auditor either in monetary or reputational terms. Secondly, whilst the court is not allowed to take account of matters arising after the loss has occurred, or the possibility of recovering compensation from other liable parties, it may nevertheless determine that the agreement is too heavily in favour of the audit firm, and recalculate it upwards, in spite of shareholder approval. Overall, it is an effective safeguard to ensure that auditors are not able to limit their liability unfairly.<sup>86</sup> Naturally, this section can work in the auditor's favour, but it is suggested not to the extent that Roach seems to propose.

The Max Planck Institute suggested that upon implementation of a Europe-wide scheme, a framework should be set up, 'to provide a set of basic criteria as to define what is fair and reasonable.'<sup>87</sup> This proposal could be transposed into the LLA scheme to reduce ambiguity, as without clear guidance here LLAs may then become, 'a source of commercial uncertainty,' something which they were designed to avoid.<sup>88</sup> This

82 Commission Staff Working Document SEC 2008/ 1975 of the 5<sup>th</sup> June 2008 an impact assessment and accompanying document to the; European Commission Recommendation 2008/473/EC of 5<sup>th</sup> June 2008 concerning the limitation of the civil liability of statutory auditors and audit firms [2008] OJ L162/39, 48.

83 Financial Reporting Council, *Guidance on Liability Limitation Agreements*, (2008) para 2.5.

84 CA 2006, s 537(1).

85 Lee Roach, "Auditor Liability: Liability Limitation Agreements: Part 2" (2010) Comp. Law. 31 (6) 167.

86 ICAEW, 'Auditors Liability Conundrum' (August 2008) <<http://www.icaew.com/en/technical/audit-and-assurance/working-in-the-regulated-area-of-audit/audit-liability/auditors-liability-conundrum>> accessed 21 February 2012.

87 Doralt, Hellgardt, Hopt, Leyens, Roth & Zimmermann, 'Auditors' liability and its impact on the European financial markets' (2008) 67(1) CLJ 62, 67-68.

88 P.E. Morris, 'Contractual Limitations on the auditor's liability: An uneasy combination of law and accounting' (2009) 72(4) MLR 607, 624.



could also help reduce the amount of potential litigation, as companies may be less likely to seize the opportunity to test the boundaries of the law if limits already exist.

At present, it appears that what the parties have agreed to, such as a reduced audit price, will provide an evidentiary basis for any determination of what is 'fair and reasonable,' although until LLAs have been tested in the courts the position remains uncertain.

In addition the difficulty of defining what is 'fair and reasonable,' there is also the question of what form an LLA should take in order to be considered 'fair and reasonable.' The FRC has provided some guidance in this area by outlining three sets of specimen principal terms where liability is limited either proportionately, to a fair and reasonable amount, or through a cap.<sup>89</sup>

In a White Paper, it was stated conversely that it would not be possible to agree a set amount, either as a cash sum or through a quantifiable formula (multiple of the audit fee).<sup>90</sup> This would effectively limit the possibilities of form to proportional liability agreed through contract, with the courts left to determine precisely what would be the 'fair and reasonable' amount. However the Government has opened the field to liability caps and other forms of limitation and whilst this flexibility could give the client and its shareholders greater options, depending on their appetite for risk, it has certainly met with some opposition. Most notably, the Institutional Shareholders' Committee (ISC) has stated that, 'agreements should be proportionate,' and that they would be unwilling to accept any agreements which would comprise a cap on liability.<sup>91</sup> Contractual proportionate liability would give parties greater autonomy and is a better option than a liability cap, as the parties can, 'set the level of liability according to the specific risk situation of the company.'<sup>92</sup> Shareholders, as the ultimate risk bearers, have to agree to any decision put forward by the directors. It appears then that in any case, the majority of LLAs will take the proportional form, as major shareholder institutions continue to exert their influence.

### Effect on Audit Quality

The use of industry standards reflects a general attempt by the Government to improve audit quality (see above), as it is believed that one of the main disadvantages of limiting liability is that auditors will be less careful as they are no longer deterred by the threat of unlimited liability. This is a fairly hollow argument. As noted in section B, there is already a strong review culture within accountancy firms. The opportunity of gaining other financial service contracts and the need to safeguard their reputation would suggest that in business terms, the firms would want to carry out their audits to a high quality. The Commission also points to the 'pivotal role' of audit regulators,<sup>93</sup> and that the required external independent quality assurance system of the 8<sup>th</sup> Company Law Directive<sup>94</sup> would provide a, 'more appropriate driver for audit quality than civil liability rules.'<sup>95</sup>

Audit quality is difficult to measure as it depends on investor and company perceptions and the mere fact that a limitation has been imposed on liability may affect confidence, although this could be neutralised by the strong external regulation of audit quality through independent bodies.<sup>96</sup> Provided, therefore, that there are other sufficient external safeguards and stringent internal quality processes in place, it is likely that the use of an LLA will have little or no effect on the quality of the audit conducted.

<sup>89</sup> FRC (n 83) Appxs B, C and D.

<sup>90</sup> DTI (n 19) 26.

<sup>91</sup> Institutional Shareholders Committee, 'Statement on Auditor Liability Limitation Agreements' (June 2008).

<sup>92</sup> Doralt, Hellgardt, Hopt, Leyens, Roth & Zimmermann (n 87) 66.

<sup>93</sup> Commission Staff Working Document (n 82) 46.

<sup>94</sup> Directive 2006 / 43/ EC- statutory audit directive Art 29 & 32.

<sup>95</sup> Commission Staff Working Document (n 82) 46.

<sup>96</sup> *ibid* 47.



### Third Party Liability

As discussed above, an LLA is a contractual limitation agreed by the auditor and its client. It has no effect on claims by third parties against the auditor. The ICAEW issued guidance in relation to this and suggested that general industry measures, such as 'hold harmless' letters, be used to prevent the client passing on information to third parties without the auditors' consent, thereby ensuring that their liability to such parties is controlled and restricted.<sup>97</sup>

It is right that LLAs should not apply to third parties as they are involuntary creditors and have no means to negotiate the terms of the agreement. Interestingly, the Commission stated in their recommendation that a, 'limitation of liability should apply against the company audited and any third party entitled under national law to bring a claim for compensation.'<sup>98</sup> As noted in section B, third party liability is already very restricted in England and Wales through the *Caparo* jurisprudence and it seems that the Commission's real motive making this suggestion was to reflect the law as it already stands in many member states.<sup>99</sup>

### *III) Industry Use of LLAs*

#### Compatibility with Directors' Duties

Could agreeing to an LLA be contrary to a director's duties, particularly as to whether a recommendation to use an LLA amounts to a breach of statutory duties (principally s.172 to promote the success of the company)?<sup>100</sup>

This possible incompatibility could be fatal for LLAs and consequently, the ICAEW engaged a QC to provide advice on the matter. Although it does not have legal authority, in the absence of case law, this opinion provides a useful insight into what could happen if such a point were litigated. He notes that it is, 'common place for a company to accept a contractual term which excludes or limits the liability of an opposite contracting party.'<sup>101</sup> He provides a non-exhaustive list of points a director should consider, such as the objective fairness and reasonableness of the terms.<sup>102</sup>

When evaluating the effect of the Companies Act in 2006, the Department of Business, Innovation and Skills recognised the need for further clarity on this issue as, 'companies appear to be entering agreements whilst openly acknowledging they do not know of any benefits to their company.'<sup>103</sup>

#### LLAs and the Securities and Exchange Commission (SEC)

Possibly the largest obstacle faced by LLAs is the refusal of the SEC to accept any form of liability cap.<sup>104</sup> This effectively means that clients who enter into LLAs will not be eligible to be listed on the US stock mar-

97 ICAEW, 'Managing the professional liability of accountants' s. F <<http://www.icaew.com/en/members/regulations-standards-and-guidance/practice-management/managing-professional-liability#ICAEW11>> accessed 1 March 2012.

98 European Commission Recommendation 2008/473/EC of 5<sup>th</sup> June 2008 concerning the limitation of the civil liability of statutory auditors and audit firms [2008] OJ L162/39 para 3.

99 Commission Staff Working Document (n 82) 16-17.

100 Roach (n 85) 168.

101 Hapgood, 'Liability Limitation Agreements under the Companies Act 2006: Opinion' para 7 <[http://www.icaew.com/~media/Files/Technical/Audit-and-assurance/Auditor%20liability/liability\\_agreements\\_under\\_company\\_act\\_2006\\_opinion.ashx](http://www.icaew.com/~media/Files/Technical/Audit-and-assurance/Auditor%20liability/liability_agreements_under_company_act_2006_opinion.ashx)> accessed 21 February 2012.

102 *ibid* paras 9-12.

103 Department for Business Innovation and Skills, *Evaluation of the Companies Act 2006, Executive Summary*, (Infogroup/ ORC International, 2010) 14.

104 Iain Redford and Frances Brown, 'Limiting Auditors' Liability' (March 2009) <<http://www.bristows.co.uk/?pid=46&nid=1332&level=2>> accessed 21 February 2012.



ket as they would not meet the independence requirement in the Regulations.<sup>105</sup>

This is an, 'effective sterilisation of the LLA regime in parts of the top-tier corporate sector.'<sup>106</sup> Peter Wyman, a partner at PwC, has even gone as far as to say that, 'this is the door being slammed in reality.'<sup>107</sup> Although a BIS report mentioned stated that there had been a 17% uptake amongst the participants, many stakeholders were sceptical about the use of LLAs, not only because it was only in the auditor's interests to use such an agreement, but also as US dual listed companies were unable to enter them.<sup>108</sup> The Competition Commission reported in 2012 that not one of the Big Four had entered into LLAs in relation to statutory audits of their FTSE 350 clients.<sup>109</sup> The reasons cited by Ernst Young included the fact that the SEC had refused to permit such agreements. The overriding consensus between the firms was that, '(a)lthough theoretically possible, such provision for liability limitation agreements in the CA 2006 had not proved acceptable to companies in practice,'<sup>110</sup> and that they would be facing the prospect of unlimited liability for the foreseeable future.

#### IV) *LLAs and the European Approach*

There was a contemporaneous attempt by the European Commission to research this area and the conclusion was reached in the 2008 Recommendation that, 'unlimited liability combined with insufficient insurance cover is no longer tenable,'<sup>111</sup> auditors should be able to limit their liability in some way. A precise method was not prescribed by the text of the recommendation; however three key principles were suggested:

1. The limitation of liability should not apply in the case of intentional misconduct on the part of the auditor;
2. A limitation would be inefficient if it does not also cover third parties;
3. Damaged parties have the right to be fairly compensated.<sup>112</sup>

As previously discussed, English law is different with regard to third parties and this could hinder a common European solution. Furthermore, whilst intentional misconduct is covered through criminal law, as considered in section B, its reach is not very wide and if civil law limitations do not address this sufficiently, a gap in public protection could arise. This is only a recommendation and, as such, is not binding upon member states.<sup>113</sup> There could be the issue that, if this were to become a directive, the LLA would no longer be compliant, although further action is yet to be taken nearly 5 years on. While this seems unlikely, if concerns as to proportional liability, for example, grow and the EU determines that all methods should be proportional, the LLA may run into some difficulties. Although purely hypothetical, this could mean that some amendments may have to be made to the scheme to bring it in line with EU legislation.

#### E. Conclusion

The introduction of LLAs have therefore had somewhat of a neutral impact on the audit industry. With not one of the Big Four using them when auditing their largest clients, it could be argued that they have failed to reach their purpose of alleviating the effects of the 'deep pocket syndrome' and preventing future large-

<sup>105</sup> 17 Code of Federal Regulations § 210.201 (USA)

<sup>106</sup> Morris, P.E. (n 88) 624

<sup>107</sup> J Hughes, 'SEC blocks auditor liability deals' Financial Times (London, March 10 2009) <<http://www.ft.com/cms/s/0/0c242174-0dbb-11de-8ea3-0000779fd2ac.html#axzz1ooAypsRG>> accessed 13 March 2012.

<sup>108</sup> Department for Business Innovation and Skills, *Evaluation of the Companies Act 2006, Volume One*, (Infogroup/ ORC International, 2010) 133-134

<sup>109</sup> Competition Commission, *Statutory Audit Services Market Investigation: Liability, Insurance and Settlement*, (2012) 5.

<sup>110</sup> *ibid*.

<sup>111</sup> European Commission, 'Auditing: Commission issues Recommendation on limiting audit firms' liability' MEMO (2008) 366.

<sup>112</sup> *ibid*.

<sup>113</sup> Roach (n 85) 171



scale collapses, meaning audit firms are still facing unlimited liability. Further issues as to whether LLAs are compatible with Directors' duties and the lack of incentive and will of companies to suggest the possibility of using an LLA to shareholders has meant even middle-tier firms have found the regime, 'extremely limited in its capability.'<sup>114</sup>

The law on negligence and the liability of auditors in this area was already fairly restrictive. Moreover, whilst their effectiveness can be questioned, there were already a number of schemes and opportunities in place for the audit industry to limit their liability further. Claims that without further restrictions there would be a real possibility of a collapse of one of the Big Four were unsubstantiated, and it has been contended that there was no real need for subsequent limitation.

The real argument behind these reforms was that the law was ultimately unfair to auditors. This has been disputed, but even if it was, it is suggested that rather than the introduction of LLAs, a better-placed solution would have been a reform of the law regarding joint and several liability. Since the introduction of the LLA scheme, many professional accountancy bodies such as the ACCA have called for a system of fully proportionate liability for auditors, rather than contractual limitations or caps. They argue that, in light of the recent financial crisis, auditors will be expected to assume greater responsibilities and therefore greater exposure. This exposure, they argue, cannot effectively be limited through insurance and thus a system of proportionate liability is required to allow firms to undertake these additional responsibilities.<sup>115</sup> Clearly, the audited companies are unlikely to be happy with such a system, however if they and their members are not willing to agree to contractual limitations on liability, it follows that the only way to effectively reduce the auditor liability to what the audit firms consider to be a fair and reasonable amount is by imposing such limits across the board.

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<sup>114</sup> Competition Commission (n 109) 6

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# **Are International Human Rights selfish?**

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## Abstract

*It is an unsettling truth that the yellow scrolls of history are replete with records of destruction and acrimony. Generation upon generation, from one century to the next humanity frequently erected walls of seclusion and discrimination based on race, nationality, belief etc. But walls fall and as they crumble a wind of change often swirls over the ruins. Yet, humanity alone brings about this change as an antidote to the perils and turmoil that befall nations; an antidote that is laden with the heavy burden of doing right what History did wrong. This antidote morphs into various forms: at the national level, eg. Declaration of Rights of Man and the Citizen, France 1789 or at the international level, eg. Universal Declaration of Human Rights (The Declaration) 1948. This discussion explores the international method of protecting the 'natural and imprescriptible rights'<sup>1</sup> of all people. It acknowledges the status of International Human Rights (IHR) as a legal, either enforceable or persuasive, source of global law.*

## Introduction

As a world community emerges from the necessities of globalisation, IHR become an indispensable voice of global morals and justice. Yet, IHR continuously face an allegation that they lack a balanced representation, that they are an offspring of Western civilisation. Moreover, IHR face the accusation that they rely inordinately on State participation. *Prima facie*, IHR seem to be generous to individuals but demanding towards States. However, there are concerns too that the extensive liberal content of IHR reflects a Western home grown ideology. This discussion seeks to (a) look into the State-individual relationship and (b) investigate whether IHR are a mere expression of any Western political and ideological interests, as some academics have argued. The International Covenant on Civil and Political Rights (ICCPR) and the International Covenant on Economic, Social and Cultural Rights (ICESCR) will act as points of reference. Is it possible to enact an effective global legal system, operating independently and regardless of any political interest?

In order to provide a thorough analysis, an explanation of the meaning of the term selfish in conjunction with IHR is required. Jurisprudence and philosophical commentary may disagree as to what is termed "IHR" and the part that individuals play in IHR as opposed to their role in domestic human rights etc. However, this discussion is confined within the legal meaning of IHR, comprising of declarations, covenants, etc which seek to declare and/or guarantee the rights of all people at an international level. In analysing whether IHR are selfish three main points will be discussed. Firstly, a definition of the term selfish in conjunction with IHR will be provided. Secondly, the State-individual relationship will be considered and finally the West non-West relationship will be dealt with.

## A Theoretical Approach: Can International Human Rights Be Selfish?

Two approaches may be made towards the interpretation of IHR: the formal or the practical approach. Philosophical approach will not be argued here. The Formal approach looks at substantive documents, covenants and conventions. The practical approach analyses the effects that IHR may have on the society. In defining the term 'selfish' a hybrid method of interpretation, using the formal and the practical approaches, will be adopted. Only after establishing the method of application, it is possible to provide a thorough answer to the title of this discussion.

Thus the interpretation of selfish becomes a necessity as to brandish an ample entity, as is IHR, ultimately selfish or unequivocally generous per se would be incorrect. This will be explained below. Suffice to say

<sup>1</sup> The Declaration of the Rights of Man and the Citizen 1789 <<http://avalon.law.yale.edu.html>> accessed April 2012



here that for the sake of correctness an analysis of the application of the term selfish to IHR is required in order to avoid any misunderstanding of IHR's activity in practice. How, does the term in question apply to IHR?

Oxford Dictionaries define selfish as follows: 'Selfish - (of a person, action, or motive) lacking consideration for other people; concerned chiefly with one's own personal profit or pleasure.'<sup>2</sup> Other dictionaries define the adjective similarly: 'Selfish - chiefly concerned with one's own interest, advantage, etc, especially to the total exclusion of the interests of others.'<sup>3</sup> In both definitions "selfish" entails the existence of consciousness. In other languages, an almost identical definition is given. In French for example, the word selfish, ie *égoïste*, is defined as follows: '*Personne qui ne recherche que son intérêt, son plaisir, sa satisfaction personnelle*'<sup>4</sup> – a person concerned with one's own personal interest, pleasures and satisfactions. What underpins the word selfish is its human (person) and egoistic (personal profit) nature.

Any personification of IHR calls for a direct application of the dictionary meaning of selfish to IHR. Since IHR lack the conscience attribute then a metaphorical application is necessary. Yet, a mere metaphorical approach to selfishness in conjunction with IHR suggests that the latter are prescribed with a potential to benefit some personal interests other than human rights interest. This would be an incorrect assumption because, at least formally IHR guarantee the recognition of human rights. Their interests are intrinsic with the interests of human rights. In the sphere of IHR – formally speaking – the rights of the people are perceived as their inherent<sup>5</sup> entitlement, not as ideas that serve intentions disconnected to people's rights. How are IHR's interests intrinsic with the interest of the people? Would it be any different if IHR did not deal with inherent rights?

The Universal Declaration of Human Rights (The Declaration) recognises human rights as 'inherent dignity and equal and inalienable rights.' Identical are the terms used to describe human rights in ICCPR and ICESCR. The Inter American Convention on Human Rights (IACHR) has in its preamble: 'the essential rights of man...are based upon attributes of the human personality, and that they therefore justify international protection.' The Banjul states: 'reflection on the concept of human [and] fundamental human rights stem from the attributes of human beings.' The Arab Charter on Human Rights (The Arab Charter) states in its preamble: 'the eternal principles of brotherhood and equality among all human.' Lastly, the European Convention on Human Rights (ECHR) speaks of 'realisation of human rights and fundamental freedoms.' Most importantly, Member States reaffirm in the preambles of the abovementioned documents their adherence to the principles of The Declaration.

The adherence to The Declaration infers the admittance by the global community of the inherent dignity of humans and their inalienable rights. Throughout the world States have agreed not only to recognise but to initialize 'international cooperation'<sup>6</sup> or even an 'international protection'<sup>7</sup> system. Thus the fundamental and essential rights of the people are recognised at an international level as properties, inherent natural rights of the human being. In other words, formally these inherent natural rights are not an invention of personal interest; they are a discovery of human culture. This assertion may pose problems too but at least it confirms that there are no insidious interests or benefits behind these rights other than human rights interests. These are rights which people are entitled to for the sake of being people as stated in The Declaration.

The definition therefore, would have to apply to IHR both metaphorically and indirectly. This approach

<sup>2</sup> 'Oxford Dictionary' (2<sup>nd</sup> edn, Oxford University Press 2001).

<sup>3</sup> 'Collin Dictionary' <<http://www.collinsdictionary.com.html>> accessed April 2012.

<sup>4</sup> 'Dictionnaire de la langue Française' <<http://www.linternaute.com.htm>> accessed April 2012.

<sup>5</sup> The Universal Declaration of Human Rights 1948, preamble.

<sup>6</sup> The Banjul 1986, preamble.

<sup>7</sup> IACHR 1969, preamble.



would realise that IHR are capable of being selfish (metaphorically) but in effect IHR would not be capable of being selfish per se (indirectly). Thus potential selfishness is not attributed to IHR per se but to various relationships that exist under the banner of IHR, such as the State-individual relationship or Western-non Western relationship etc. It is precisely the natural and inherent traits of human rights as recognised by IHR that equate IHR's interests with the interests of people. Whether these natural rights are conclusive, whether they neglect the possibility that rights could evolve with time is a matter that goes beyond the scope of this discussion.

So far two issues have been dealt with: First, because of the inherent nature of human rights their interests are intrinsic with the interests of the people. Second, according to The Declaration, IHR recognise and declare the inherent/natural, essential or fundamental rights of people. The inherent character precludes IHR from being identified with interests other than the interests of humans. IHR are incapable of personally benefiting themselves at the expense of others. As a result, selfishness becomes an expression of perspectives and relationships that exist among IHR's subjects.

The unique application of "selfish" does not redefine the term. Its modification merely acknowledges the legal character of IHR and their complex nature. Well, can IHR be selfish? IHR are capable of being branded selfish but only metaphorically and indirectly; IHR per se cannot be selfish. Selfishness relates to the consequences and the relationships that emerge under the banner of IHR. In other words, rather than saying 'IHR are/are not selfish because...', it would be more accurate to say 'IHR are/are not selfish towards...because...' IHR, as formal legal or moral standards create relationships among their subjects. This is of interest in this discussion.

IHR per se are incapable of being selfish: as a formal compilation of rights and responsibilities, IHR seek to provide a genuine balance. Most commonly IHR face the difficult task of balancing human rights interests of individuals against any State interests including States' right to represent interests of a whole community or nation. This principle will be referred to as The Balance principle and will be dealt with in the following point of discussion. Realistically they create relationships among subjects which in turn give rise to various practical effects or even imbalances.

### **The State-Individual Relationship**

Two central subjects of IHR are the citizens and the State. The character of the State is thus twofold, (a) guarantor of human rights, and (b) potential violator of human rights. This is because certain State interests are distinguishable from the interests of individuals. It may not always be so, but with the State being a political formation, its political interests are often effortlessly distinguished from the interests of individuals as history has told. How do IHR balance the rights of individuals against the rights (political, national etc) of a State presuming that the State too is responsible for the protection of its people? This part of the discussion seeks to explore the relationship between individuals and States and the application of selfishness in the light of State-individual perspective.

#### ***A. The Balance Principle***

Two types of State authority can be distinguished: totalitarian, and liberal/democratic. A concrete example of a totalitarian regime is that of Nazi Germany, or the imposing regime of 1990's Serbia (former Yugoslavia) on Bosnia and Kosovo. During their reign, interests (rights and freedoms) of the people were compromised by the political, non-human rights interests of the state which led to genocide. Human rights are recognised as inherent in The Bill of Rights. Even though it did not come into light until after World War II this did



not justify nor excuse the Nazi regime at the Nuremberg<sup>8</sup> trials. Thus, political interest has been a factor of violation of IHR.

In democratic societies too, interests of the State are distinguishable from those of individuals. This does not mean that States and individuals are adversaries. But since States are political and complex formations, since there have been occasions when States oppressed people, the fundamental rights of the individual are guaranteed by IHR, which intend to protect human rights interests against any other non-human rights interests. In cases of a dispute between rights and interests, an ultimate decision from an authority of justice, whose job it is to interpret the norms of IHR would settle the dispute. These authorities preserve The Balance principle.

An example is the case of *Sunday Times v The United Kingdom*<sup>9</sup> (UK). This case concerned a former senior British Security Service agent who decided to publish his memoirs titled *Spycatcher*. In it he described operational organisation, methods and personnel of MI5 and also included an account of alleged illegal activities by the Security Service. The author decided to publish *Spycatcher* in Australia and later in the United States (the US). The UK government argued that the publication of *Spycatcher* was against public interest and that its publication would endanger the lives of Security Services' members. The UK government sought to ban the publication of the memoirs in both countries but without success. In the mean time, *Spycatcher* was being published in the US without constraints and the memoirs were being exported to the UK by various individuals.

The issue relevant to the present discussion begins with the publication of some parts of *Spycatcher* in the UK by Sunday Times newspaper in July 1987. The UK government sought a permanent injunction, which could ban the publication of the memoirs. During the time of the court proceedings the government succeeded in securing an interlocutory injunction that effected a suspension pending the decision of the court. The interlocutory injunction was in force from July 1987 when proceeding began with the High Court until October 1988 – nearly a year after the decision of The House of Lords was delivered. The law lords allowed the continuation of the injunction in the name of public interest. Few issues were raised in that case including for example Breach of Confidentiality, but the present discussion will focus on the interlocutory injunction issue concerning Art 10 of European Convention of Human Rights (ECHR).

Sunday Times brought proceedings against the government before the European Court of Human Rights (ECtHR). The paper arguing that the injunction breached its right to freedom of expression as guaranteed by Art 10 (1). The ECtHR agreed. It decided that the measure taken by the government (interlocutory injunction) between July 1987 and October 1988 was not 'necessary in a democratic society, in the interests of national security, territorial integrity or public safety.'<sup>10</sup> The rationale was that *Spycatcher* was published in other countries including the US and the banning of its publication in the UK did not reasonably protect the interests of national security. Although the House of Lords agreed with the government's arguments the ECtHR dismissed the argument thus ruling against the State (including the judiciary).

The case of *Sunday Times v The United Kingdom* shows how the interests of a State, even of an old democracy, can infringe human rights interests. In this case two sets of rights were in conflict: the alleged right to protect a whole nation and the right to freedom of speech. Even though the government had a right under Art 10 (2) to take measures in order to protect 'the reputation or rights of others, for preventing the disclosure of information received in confidence' the Court brushed off the argument as unfounded. Since it found that the government's measures were not necessary in a democratic society, then the government

8 R W Cooper, *The Nuremberg Trial* (Faber and Faber Ltd 2010) <<http://books.google.co.uk>> accessed April 2012.

9 *Sunday Times v. The United Kingdom* (No.2), (Application no. 13166/87), Strasbourg 1991.

10 ECHR, Art 10(2) 1950.





had no interests to balance: Convention freedoms needn't be weight against national (all inclusive) rights because according to ECtHR there existed no risk to national security. The court decided in favour of freedom of expression thus determining that not only was there no risk to national security but that the UK government had no claim under Art 10 (2). The balance principle was preserved.

### ***B. States Obligation to Comply with Judicial Decisions***

Regardless of any judicial decisions IHR would be unable to uphold human interests should States refuse to comply with their decisions or even become parties to international treaties or covenants etc. For example, Saudi Arabia has neither signed nor ratified the ICCPR. The Arab Charter, which guarantees the protection of fundamental rights, has not been enacted yet. Individuals whose rights might be violated in Saudi Arabia lack any practical international remedy on occasions when Saudi Arabia is the violator. Similar is the case of the US (see further below). State participation is indispensable in materialising certain judicial decisions and upholding the Rule of Law.

As suggested above, some States overtly fail to comply with judicial decisions while others abide by a committee's decision albeit they enjoy the practical feasibility not to follow it. Below two cases will be referred to: the case of *Sandra Lovelace v Canada*<sup>11</sup> (1977) (Lovelace) and the case of *Toumi v Italy*<sup>12</sup> (2009) (Toumi).

The *Lovelace* case concerns a Maliseet Indian woman (the author) who lived in an Indian reserve in Canada. The author brought a claim before the Human Rights Commission in 1981, claiming that Canada discriminated against her on grounds of sex contrary to, among other articles, Article 2 (1) (Right to Equality), and 27 (Respect of Minority Rights and Cultures etc) of the ICCPR. The discriminatory act was S.12 (1) (b) of the Indian Act (1951), which provided that:

An Indian woman who is a member of a band ceases to be a member of that band if she marries a person who is not a member of that band. (a) As such, she loses the right to the use and benefits.<sup>13</sup>

An Indian man who marries a non-Indian woman however, does not lose his Indian status.<sup>14</sup> Pursuant to this act the author lost her status and rights after marrying a non Indian in 1970. The Human Rights Commission decided:

[The] Committee, acting under article 5 (4) of the Optional Protocol to the International Covenant on Civil and Political Rights, is of the view that [the author] has been denied the legal right to reside on the Tobique Reserve, disclose a breach by Canada of article 27 of the Covenant.<sup>15</sup>

The decision in that case is regarded as a significant not only because it represents an important step forward in eliminating gender discrimination in Canadian law<sup>16</sup> but it also is testimony of the fact that the committee system offers a somewhat voluntary protection in that any initiative improving a certain situation rests solely with the will of a violator State. Canada complied, and The Indian Act 1951 was amended in 1985 with the discriminatory provisions being revoked.<sup>17</sup> However, in 1980, before the case reached the commission the Canadian government had recognised that the provisions of the Indian Act needed serious reform<sup>18</sup> which

<sup>11</sup> *Sandra Lovelace v Canada* [1977], Communication No. R.6/24, U.N. Doc. Supp. No. 40 (A/36/40) at 166 [1981].

<sup>12</sup> Case 25716/09 *Toumi v Italy* [2009].

<sup>13</sup> *Sandra Lovelace v Canada* [1977], Communication No. R.6/24, U.N. Doc. Supp. No. 40 (A/36/40) at 166 (1981).

<sup>14</sup> Ibid

<sup>15</sup> *Sandra Lovelace v Canada*, Communication No. R.6/24, U.N. Doc. Supp. No. 40 (A/36/40) at 166 (1981)

<sup>16</sup> International Network for Economic, Social and Cultural Rights, <<http://www.escr-net.org>>, accessed April 2012.

<sup>17</sup> Ibid

<sup>18</sup> *Sandra Lovelace v. Canada*, Communication No. R.6/24, U.N. Doc. Supp. No. 40 (A/36/40) at 166 (1981),



might explain why there was no reluctance on the part of the Canadian government to comply with decision. However, had it refused to comply there would have been neither sanctions nor means of enforcing the decision in question.

The sole obligation that the ICCPR places on States is for them to 'undertake to respect and to ensure to all individuals within its territory the rights recognized.'<sup>19</sup> It does not stipulate what follows should a State refuse to comply. In other occasions many governments either refuse to or delay their submission of reports in accordance with Art 40 of ICCPR. For example, 'as of 31 January 2004, 185 initial reports of States parties required under the various treaties were overdue.'<sup>20</sup> Moreover, 114 State reports had been overdue for more than five years<sup>21</sup>. A delay of five years could have a decisive impact on people's lives. Seen in this light, one may argue that IHR are selfish because they possess a practically absolute discretion on States to the detriment of individuals who may be unable to avail themselves of any deserved remedies.

Another example is the case of *Toumi*. In that case the applicant was a Tunisian national who had been sentenced to six years' imprisonment for international terrorism in Italy. When he was released the Italian authorities sought to deport him to Tunisia. The applicant, aware of the authorities' intention made an application to the ECtHR under Rule 39 of the Rules of the Court which provide for the setting of any interim measure<sup>22</sup> barring the government from deporting an individual prior to the ECtHR's verdict. Notwithstanding, the Italian authorities decided to deport the applicant to Tunisia, blatantly disregarding their obligation under Art 46 (1) of ECHR requesting States party to the convention to 'undertake to abide by the final judgment of the Court in any case to which they are parties.'

Comparing the two cases, in the *Lovelace* case although sanctions could not be incurred on the non-compliant State, Canada nonetheless followed the decision of the committee. Italy, on the other hand was bound by the decisions of the ECtHR and yet derogated from its obligation. Furthermore, under Art 46 (5) of ECHR 'the Committee of Ministers of the European Council to decide on the measures to be taken against a non complying state.' Thus, even in cases when IHR provide measures there is no imminent method of ensuring the upholding of the Rule of Law and the protection of individuals' rights. Moreover, Canada had long since recognised a flaw in the law and was considering an amendment. Whether the Canadian government would have cooperated had it not shared the opinion of the committee remains a matter of speculation. The bottom line is that IHR would be ineffective without full State cooperation.

However, in the words of the famous law lord, one must not focus so much on detecting any drawbacks that accomplishments and achievements pass unappreciated<sup>23</sup>. The fact is, that IHR do contribute immensely towards the improvement of human rights, be it at the international or the regional level. However, State discretion and the manner with which it controls human rights activities is relevant because the concerning issue of justiciability (at the United Nations (UN) level) and State cooperation was addressed by the Human Rights Committee (HRC) in 1994:

Of particular concern are widely formulated reservations which essentially render ineffective all Covenant rights which would require any change in national law to ensure compliance with Covenant obligations. No real international rights or obligations have thus been accepted.<sup>24</sup>

One of these reservations is US's reservation to Art 15 (1) clause 3 of ICCPR stating: 'If, subsequent to the commission of the offence, provision is made by law for the imposition of the lighter penalty, the offender

<sup>19</sup> ICCPR 1976, Art 2(1).

<sup>20</sup> O De Schutter, *International Human Rights Law* (Cambridge University Press 2010).

<sup>21</sup> Ibid

<sup>22</sup> *Rules of Court*, (European Council 2009).

<sup>23</sup> T Bingham, *The Rule of Law* (Penguin 2011).

<sup>24</sup> General Comment 24 (52), U.N. Doc. CCPR/C/21/Rev.1/Add.6 (1994).



shall benefit thereby.' The US government's rationale behind the reservation was that, because US law generally applies to an offender the penalty in force at the time the offence was committed, then 'the United States does not adhere to the third clause.'<sup>25</sup>

Now, the point of Art 15 (1) is to benefit offenders, to do justice etc. The whole idea is that the offender shall benefit from future lighter penalties. If a State reserves the right to apply to an offender the penalty in force at the time the offence was committed – harsher than a latter legislation – then the whole paradigm of imposing a lighter penalty fails to be recognised by the State. Such reservations immune States from international justice.

The HRC's concerns in 1994 and the examples of the *Lovelace* and *Toumi* demonstrate that IHR rely almost unconditionally on State cooperation for the attainment of IHR interests. Even though disobeying States belong to rare and unusual occurrences, the fact that States are at liberty to pursue their intentions unrestricted (practically) is evidence that IHR are more or less at the mercy of any State's integrity. Seen in this light, it may be argued that as far as the State-individual relationship is concerned, IHR may be regarded as relatively selfish towards individuals and generous towards States, an entity against which IHR seek to protect individuals' rights.

### **International Human Rights and the Western-Non Western Relationship**

According to some scholars, such as Makau Mutua, to envisage IHR as a representation of all peoples' beliefs would be to envisage an aspiration which has yet to be materialized. In his article *The Ideology of Human Rights* Mutua sees in human rights the trumpet of Western philosophical and political ideology. The author embarks on a discussion that treats the whole paradigm of human rights as a mere aggregate of civil and political rights:

The main focus of human rights law, however, has been on those rights and programs that seek to strengthen, legitimize, and export political or liberal democracy. Inversely, most of the human rights regime is derived from bodies of domestic jurisprudence developed over several centuries in the West. The emphasis, by academics and practitioners, in the development of human rights law has been on civil and political rights... As one author has remarked the West was able to "impose" its philosophy of human rights on the rest of the world because in 1948 it dominated the UN.<sup>26</sup>

The author raises concerns which fall under two main headings: (a) the concern that human rights focus on exporting liberal democracies (found in ICCPR), and (b) the concern that civil and political rights are of Western cultivated tradition. The author suggests in his article a de facto hierarchy among rights with civil and political rights at the top of the pyramid and socio-economic rights in the bottom. This hierarchy, it is argued is a reflection of the ideology and attitude of the West towards human rights. In other words, the West forces its political philosophy by elevating the importance of civil and political rights, thus crafting a gap between them and socio-economic rights, which as a result are treated as inferior rights. In this light, are IHR selfish: do political rights override socio-economic rights?

#### ***A. Exporting Political Ideologies?***

Mutua's first concern stems from the premise that the main focus of human rights law has been on those rights and programs that seek to strengthen, legitimize, and export political or liberal democracy. The principle that Liberal democracies cherish is the freedom of the individual to realize his or her human

<sup>25</sup> General Comment 24 (52), U.N. Doc. CCPR/C/21/Rev.1/Add.6 (1994).

<sup>26</sup> M W Mutua, 'The Ideology of Human Rights' [1996] Vol. 36 Virginia Journal of International Law 589.



capacities<sup>27</sup>, freedoms and rights such as those enshrined in ICCPR. Mutua argues as seen above that the West, that the US in particular, had the advantage of dominating the UN in 1948 when The Declaration was proclaimed, and therefore were able to impose their human rights philosophy on the rest of the world. Have civil and political rights superseded socio-economic rights, based on the assumption that the West had the political advantage in 1948?

In 1948, it is said, many African and Asian countries were colonies of European powers<sup>28</sup> and unable to vote, while South American countries, the representatives of Third World, have a European worldview.<sup>29</sup> The Socialist bloc countries 'fearing that socio-economic rights had been downgraded only abstained.'<sup>30</sup> Therefore, argues Mutua, civil and political rights override socio economic rights. However, Jack Donnelly and Daniel Whelan explain that the West was more concerned with how best to recognize and implement economic and social rights in the emerging body of international human rights law<sup>31</sup>. The West had no intent to downgrade socio-economic rights. For example, in 1951 whilst the debate on the covenants (civil and political rights and socio and economic rights) was taking place the US was instructed:

[To] propose two covenants, should there be majority sentiment for that position. If not, the US should ask the General Assembly to defer its decision and request the Commission to prepare three instruments for consideration in 1952: an instrument with all the rights; one with just civil and political rights; and one with just economic, social, and cultural rights. Should both of these alternatives prove impossible, 'the United States Delegation should not oppose but should vote for the inclusion of economic, social and cultural rights in a single Covenant.'<sup>32</sup>

The defence offered by Donnelly and Whelan however, has not passed without criticism. One of their critics, Suzan Kang argues that the West in general and the US in particular have shown little interest for legalising and further improving socio-economic rights and therefore they have been keen on advancing their liberal ideology:

Possible rationalist explanations for the West's preference to divide human rights could include a coordination problem or political fears that a highly legalized document might infringe on sovereignty... the costs of non-compliance can be too high. This may help to explain the United States "serious concerns" about the practicality of including economic and social rights. However, if Western states feared the effects of a singular human rights covenant, this political concern suggests that social and economic rights were not as "central" as civil and political rights to Western states and society.<sup>33</sup>

Firstly, why should the US propose two covenants instead of a single one? Answers vary. From Mutua's point of view this goes to show how a cautious Western power, based purely on ideological convictions, refused to be bound by a single document containing provisions on socio-economic rights. The US was to propose three documents. Today there are three documents: The Declaration, ICCPR and ICESCR. However, whether this was a result of the West dominating the UN or the result of lack of support is more a matter of opinion than of fact.

Secondly, the point that Kang accentuates, namely that Western countries feared a highly legalised document

27 C B Macpherson, *The Life and Times of Liberal Democracy* (Oxford University Press 2012).

28 C B Macpherson, *The Life and Times of Liberal Democracy* (Oxford University Press 2012).

29 M W Mutua, 'The Ideology of Human Rights' [1996] Vol. 36 Virginia Journal of International Law 589.

30 Ibid

31 J Donnelly and J D Whelan, 'The West, Economic and Social Rights, and the Global Human Rights Regime: Setting the Record Straight' [2007] Vol. 29 Human Rights Quarterly 908.

32 J Donnelly and J D Whelan, 'The West, Economic and Social Rights, and the Global Human Rights Regime: Setting the Record Straight' [2007] Vol. 29 Human Rights Quarterly 908.

33 S L Kang, 'The Unsettled Relationship of Economic and Social Rights and the West: A Response to Whelan and Donnelly' [2009] Vol. 31 Human Rights Quarterly 1006.



is worrying. Marginalising the relevance of socio-economic rights in order to eschew scrutiny, especially by a domestic public is good enough a reason to assume that IHR have been drafted in a way that benefits political – not human rights – interests. To deprive people of the right to scrutinise the government on issues of human rights clearly shows political interests overriding human rights interests. On the other hand a genuine fear that a single legalised document might infringe on sovereignty would not be illegitimate.

An infringement of State sovereignty might be interpreted as an indirect infringement of people's democratic right of delegation. The ICCPR actually has a greater legal implication on States, than does the ICESCR, for the latter provides a gradual and progressive technique for the attainment of socio-economic rights, which the West believes to be the best way of achieving these rights. It awards governments discretion as to the time and the method they employ to implement these rights (see below). Its demands are not categorical, they are *aspirational*. The former on the other hand, enumerates rights and liberties that States undertake to abide by upon becoming parties to the covenant. For example, Art 2 (1), Part II of both the aforementioned covenants state that each State Party to the present Covenant (underlining is added for comparative purposes):

...undertakes to respect and to ensure to all individuals within its territory and subject to its jurisdiction the rights recognized in the present Covenant. (ICCPR)

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

The ICCPR requires States to 'respect and to ensure' whereas the ICESCR enables states to 'take steps with the view of achieving progressively' its human rights obligations. The former imposes on States a direct obligation whereas the latter grants them the option of the choice of methods they could employ to fulfil human rights obligations. The only occasion when it might be argued that the ICESCR impose a direct duty on the State is when Art 2 requires that States adopt a 'legislative measures'. Yet the ICCPR too requires States to take legislative measures in Art 2(2). Therefore, both covenants vest on States a duty to respect and ensure the rights enshrined in the covenants. However, ICESCR is less compelling and not as directly applicable as the ICCPR, which is much more demanding for the reasons stated above.

It follows that, if any of the covenants were to raise concerns about sovereignty it would be ICCPR, which the US has ratified; not ICESCR. Countries who might be concerned with sovereignty infringement would not have chosen to ratify a more legalised covenant and refrain from either acceding or ratifying a less imposing one. Furthermore, the ICCPR was affixed with two extra optional protocols. The first Optional Protocol allows for individual complaints (Art 1) as opposed to State reports system that the ICESCR provided at the time of discussion (Art 19). However, in 2008 the General Assembly adopted an Optional Protocol to the ICESCR. It allows for individual complaints to the commission (Art 2). The protocol provides for international aid and funds (Art 14) – something that Optional Protocol to the ICCPR lacks. For this reason the issue of justiciability will not be considered any further.

Therefore, it would not be unordinary, to believe as Kang suggests that social and economic rights were not as central as civil and political rights to the West.<sup>34</sup> For example, after the invasion of Iraq in 2003, under the auspices of the US provisional authority, Paul Bremer passed a number of orders restructuring the Iraqi economy; Saddam Hussein's restrictions on trade unions and collective bargaining remained untouched.<sup>35</sup>

One of the dubious trade union laws is Resolution 150. It prohibits public sector workers from organising

<sup>34</sup> S L Kang, 'The Unsettled Relationship of Economic and Social Rights and the West: A Response to Whelan and Donnelly' [2009] Vol. 31 Human Rights Quarterly 1006.

<sup>35</sup> Ibid





in formations such as trade unions, and bars all public sector workers from going on strike.<sup>36</sup> The English version published in the Official Gazette of the Republic of Iraq states:

The provisions of the Labour Code, Act No. 150 (LS 1970 - Iraq 1, 1973 - Iraq 1A, 1B) and of the Law of Pension and Social Security for workers (No. 39 of 1971) shall be restricted to workers in the private, mixed and co-operatives sectors. Union organisations for workers and the jurisdiction of the labour courts shall also be restricted to those sectors.<sup>37</sup>

This act has attracted strong criticism from the International Labour Organisation because it is in breach of Art 8 (1) (a) of ICESCR: 'The right of everyone to form trade unions and join the trade union of his choice' and Art 8(1) (b): 'The right to strike provided that it is exercised in conformity with the laws of the particular country.' So, a Western democracy as is the US would have considered the trade unions issue if socio-economic rights were central to the US ideology, especially as Iraq has ratified the ICESCR since 1971.<sup>38</sup>

The political ideology of liberal democracies seems to have been a factor for determining what was considered central and what was not. The political ideologies inflamed debates that lead to Political-Economic debates. A socialist East focused on socio-economic rights as it fitted well with their Marxist ideology on the active role of the State – State interference should provide people with the enjoyment of fundamental economic entitlements.<sup>39</sup> A capitalist West pressed for the recognition of its own liberal rights and liberties as it fitted with the freedoms and liberties idea – less interference by the state in everyday life. These are the ideologies that dominated the Cold War.<sup>40</sup> The political pressure and the ideological war that was taking place after 1945 between the capitalist West and the socialist East left its mark on IHR. They did not escape the contemporaneous ideological battle. The Political-Economic division is not a mere result of the capitalist-socialist rivalry. Its roots lay deep in the cultural conscience of the West, it has been argued.

## **B. *A Western Domestic Jurisprudence?***

Mutua's second point is that most of the human rights regime 'is derived from bodies of domestic jurisprudence developed over several centuries in the West.'<sup>41</sup> First it seems as if Mutua denounces IHR for being a breed of an ideology that was cultivated in confined Western domestic customs. One would not be mistaken to think so. But this statement must not be taken out of its context. The author strives to emphasise how the Western customary moral norms and ideology takes centre stage in the international arena; he does not denounce IHR as some malicious creation nor does he consider political rights to be futile or fictitious. On the contrary, he acknowledges their importance but criticises the manner with which Western countries and especially the US dominated IHR:

The Universal Declaration of Human Rights laid the foundation for human rights movement; those ideas have been embraced by diverse peoples across the earth. That fact is undeniable... Those same people who have embraced that corpus also seek to contribute to it.<sup>42</sup>

For example, freedom of belief and freedom of expression (as recognised by ICCPR), are guaranteed by Articles 35 – 40 of the constitution of The People's Republic of China (1982): 'Citizens of the People's Republic of China enjoy freedom of speech, of the press, of assembly, of association'; by Amendment I of

36 Annual Survey of Violations of Trade Unions Rights (2008), <<http://www.survey.ituc-csi.org>> accessed April 2012.

37 International Labour Organisation Iraq, NATLEX <<http://www.ilo.org>> accessed April 2012.

38 United Nations Treaty Collection (2012), <<http://www.treaties.un.org>> accessed April 2012.

39 Henry J Steiner and Alston P Goodman, *International Human Rights in Context* (3<sup>rd</sup> edn Ashford Colour Press Ltd 2007).

40 S L Kang, 'The Unsettled Relationship of Economic and Social Rights and the West: A Response to Whelan and Donnelly' [2009] Vol. 31 Human Rights Quarterly 1006.

41 M W Mutua, 'The Ideology of Human Rights' [1996] Vol. 36 Virginia Journal of International Law 589.

42 M W Mutua, 'The Ideology of Human Rights' [1996] Vol. 36 Virginia Journal of International Law 589.





The Bill of Rights of USA (1789): 'Congress shall make no law...prohibiting the free exercise thereof; or abridging the freedom of speech or of the press'; and by Art 19 of the constitution of India (as amended in 2007): 'All citizens shall have the right—(a) to freedom of speech and expression.' Many nations worldwide embraced The Declaration and many national constitutions have enshrined the principles of liberal democracies as essential and fundamental rights of people.

What Mutua argues therefore, is not that this domestic jurisprudence is unacceptable to non-Western countries, but rather, that Western domestic jurisprudence predominate IHR. Whether this is a result of the drafter's Western education, as Mutua points out, or a mutual and a universal understanding of the fundamental freedoms and rights is debatable. Even though political rights such as the right to liberty<sup>43</sup>, right to life<sup>44</sup> and right to free speech<sup>45</sup> derive from liberal ideologies cherished by philosophers such as John Locke and John Rawls etc, whose writings have had a real influence on Western jurisprudence, the inclusion of these rights in The Bill Of Rights is not necessarily a political tactic. Although human rights principles like freedom of belief, freedom of expression and right to liberty etc were developed by European and US thinkers, these rights are endorsed by the global community.

So far two propositions were considered, firstly, for its own political fears and for the sake of its own philosophical beliefs, the West succeeded in elevating the importance of civil and political rights to the detriment of socio-economic rights. Secondly, the fact that liberal values originated in capitalist market societies is not in itself a reason why the central ethical principle of liberalism need only be confined to such societies.<sup>46</sup> Above it was shown that the so-called Western ideologies are embraced by many nations around the globe. The better opinion seems to be that IHR reflect the glare of Western and Socialist ideologies, with the West having the upper hand. However, Western countries too, have shown regard for socio-economic rights expressed in the form of the Welfare State.

### ***C. The Welfare State and International Cooperation.***

Some Western countries have forged a warmer relationship with socio-economic rights. They developed a Welfare system guaranteeing access to many socio-economic rights such as the right to an adequate standard of living, adequate food, clothing and housing<sup>47</sup> by building public funded houses or flats etc. Some countries, like the UK began to develop as a welfare State since the beginning of the 20<sup>th</sup> century.<sup>48</sup> The UK passed laws such as: National Insurance (Industrial Injuries) Act (1946)<sup>49</sup> which provided compensation for workers who were injured at work, National Health Service Act (1946)<sup>50</sup> which facilitated access to health services and then to hospitals free of charge for the populace at large – a fact which is very true today.

Other States, like the US, fell short of realising a welfare system. US welfare bills including the New Deal<sup>51</sup> bill proposed by President Truman failed to materialize into law. The US congress refused to pass the bill which if it had been passed would have secured a minimum wage, would have improved the compensation system etc.<sup>52</sup> Nonetheless, the existence of the welfare State is no conclusive evidence that socio-economic

43 ICCPR, Art 9 (1) Part III 1976.

44 ICCPR, Art 6 (1) Part III 1976.

45 ICCPR, Art 19 (2) Part III 1976.

46 C B Macpherson, *The Life and Times of Liberal Democracy* (Oxford University Press 2012).

47 ICCPR, Art 11 Part III 1976.

48 J Donnelly and J D Whelan, 'The West, Economic and Social Rights, and the Global Human Rights Regime: Setting the Record Straight' [2007] Vol. 29 Human Rights Quarterly 908.

49 J Donnelly and J D Whelan, 'The West, Economic and Social Rights, and the Global Human Rights Regime: Setting the Record Straight' [2007] Vol. 29 Human Rights Quarterly 908.

50 Ibid

51 S L Kang, 'The Unsettled Relationship of Economic and Social Rights and the West: A Response to Whelan and Donnelly' [2009] Vol. 31 Human Rights Quarterly 1006.

52 S L Kang, 'The Unsettled Relationship of Economic and Social Rights and the West: A Response to Whelan and Donnelly' [2009] Vol. 31



rights are central to Western democracies.

For example, the UK ratified the ICESCR in 1976.<sup>53</sup> The amount of public funding it allocates to welfare alters according to political ambitions or global circumstances (from approximately 6% of GDP in 2000 to approximately 7% in 2010 but less than 7% in 2012)<sup>54</sup> Even though the UK allocates a certain portion of its GDP to domestic welfare policies it lacks any socio-economic foreign policy that would improve the implementation of those rights worldwide. Sweden, on the other hand dedicates a portion of its GNP to promoting greater economic opportunities in poor countries; the UK, the US and other powerful Western States have not made similar formal commitment.<sup>55</sup> It appears that the existence of a welfare State in itself does not necessarily indicate that socio-economic rights are central to the West. The West and especially the US must engage in global policies, similar to the political commitments in Iraq (see above) to back up any claim.

Western involvement is crucial because many of the non-Western states who favour legalised socio-economic rights are either Third World countries, where it is argued that economic progress has to be attained as a first priority,<sup>56</sup> or socialist countries that restrict their involvement within the socialist block. Many of the non-Western states lack the resources to embark on a global human rights promotion and protection schemes although they have included socio-economic rights in their regional conventions. Examples include African and South American countries. European States on the other hand have enacted the ECHR, and different from the European Social Charter, made the ratification of ECHR (excluding protocols) a precondition to membership to the Council of Europe. Therefore, the absence of Western global cooperation has given rise to the downgrading of socio-economic rights.

This issue was addressed at the Vienna World Conference (1993) by the UN committee on Economic, Social and Cultural Rights which stated that:

States and the international community as a whole continue to tolerate all too often breaches of economic, social and cultural rights which, if they occurred in relation to civil and political rights, would provoke expression of horror and outrage and would lead to concerted calls for immediate and remedial action... Such muted responses are facilitated by a reluctance to characterize the problems that exist as gross and massive denials of economic, social and cultural rights.<sup>57</sup>

The proposition, 'if they occurred in relation to civil and political rights would provoke expression of horror', refers not only to the global indifference as a whole, but also to Western powerhouses as a key player in global politics. Moreover, grievance is the parallel drawn between factual violation of socio-economic rights which provoke 'expression of horror' and hypothetical ('if they occurred') violation of civil and political rights. Such horrific socio-economic violations must include violation of primary rights such as deprivation of health or food and water etc – the civil and political equivalent of the right to life or to freedom etc, for the protection of which the West has engaged in armed conflicts.

Consequently, although some Western countries have developed Welfare States, there is lack of global cooperation. IHR not only rely on State cooperation but they also seem to have been drafted in such a manner that utilises the elevation of Western ideologies to the detriment of the rest of the world. In this light

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Human Rights Quarterly 1006.

53 United Nations Treaty Collection, <<http://treaties.un.org>> accessed April 2012.

54 United Kingdom Public Spending, <<http://www.ukpublicspending.co.uk>> accessed April 2012.

55 S L Kang, 'The Unsettled Relationship of Economic and Social Rights and the West: A Response to Whelan and Donnelly' [2009] Vol. 31 Human Rights Quarterly 1006.

56 E Brems, 'Enemies or Allies? Feminism and Cultural Relativism as Dissident Voices in Human Rights Discourse' [1997] Vol. 19 Human Rights Quarterly 136.

57 Steiner, Henry J., Alston, P., Goodman, R. (2007), *International Human Rights in Context*, (3<sup>rd</sup> Ed), Hampshire, Ashford Colour Press Ltd.



the assertion that IHR are selfish towards socio-economic rights and in the broader sense towards the Non-Western world would not be unfounded.

### **Conclusions**

From the outset, this discussion focused on dealing with the legal character of IHR comprising of treaties, covenants etc. It was necessary to distinguish between IHR's formal intentions and its practical consequences. As a formal document IHR must be interpreted by reference to the contents of documents comprising IHR. Formally, IHR cannot be comprehended as selfish. It is stipulated in The Bill of Rights, and other human rights related document, that the purpose for their enactment is the protection of human rights. In the formal sense, the interests of IHR are intrinsic with the interests of people. Formally IHR are incapable of being selfish. Practically they are capable of being selfish, but metaphorically and indirectly. Thus, IHR can potentially be selfish, but in effect, if they were selfish (colloquially), they would be facilitating the benefit of one set of interests to the detriment of another/others.

With reference to the distinction drawn between formal IHR and practical IHR, and based on the definition of "selfish" albeit IHR seek to balance individuals' rights against broader national or general security interests IHR rely absolutely on States in order for human rights interests to be upheld. Furthermore, although as a global legal authority IHR ought to be representative of global human rights interests, Western ideologies dominate the IHR arena. The better opinion then seems to be that IHR may, in the practical sense, be regarded as selfish towards individual rights and non-Western interests, because in one way or another people are at the mercy of the will of a more powerful body. However, this conclusion may change as rights evolve and perspectives on ratios created under IHR change.



# **The UK and its ‘good tax system’: an analysis based on evolving criteria**

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## Abstract

*This article presents a discussion of whether the United Kingdom possesses a 'good tax system'. There will be particular focus on the side of progressive taxation, given J.S. Mill's contribution to this area. The bases of the analysis will be provided by Adam Smith's criteria for a 'good tax system' and the principles stated in the Meade Committee Report of 1978.*

## Introduction

Taxation, being "the appropriation of property by the state (otherwise than as punishment) for the purpose of paying for government"<sup>1</sup>, is one of the fundamental components of a state's fiscal base and largely influences the development of the economy and the choices that we, as a society, make on a day-to-day basis; whether directly or indirectly. The widely-accepted criteria for a good tax system stem from Adam Smith's popular publication<sup>2</sup> concerning what is now commonly referred to amongst academics as the "Canons of Taxation"<sup>3</sup>, in 1776. However, there is dispute as to the relevance of these 18<sup>th</sup>-Century principles in the present day. It could be argued that more weight should be given to the modern principles of taxation presented in the Meade Committee Report<sup>4</sup> (MCR) of 1978. Nevertheless, it must be noted that neither of these criteria are conclusive or exhaustive in nature, and there are other matters which must be taken into account in determining the extent to which the UK tax system conforms to the traditional template of a "good tax system", and in deciding whether any change would be feasible or desirable. Each of these, amongst other issues, shall be considered in turn.

In this article the following issues shall be considered. First, there will be a consideration of the scope and content of Adam Smith's Canons, reference to J.S. Mill's views on progressive taxation<sup>5</sup>, and some attention to the extent to which the United Kingdom meets these traditional views. Secondly, attention will be given to the criteria voiced in the MCR, as well as an examination of the policy reasons for expressing each of these principles, and the wider significance of them. Finally, focus will be given to the argument that not enough attention is paid to the issues of tax evasion and avoidance, which seem to stem directly from a failure to keep compliance costs, a part of one criterion of the MCR, to as low a level as possible.

## The Traditional Viewpoint: Adam Smith and J.S. Mill

As mentioned above, the original criteria for a "good tax system" stem from Adam Smith's Canons of Taxation, published in 1776. The four criteria are as follows:

1. The subjects of every state ought to contribute towards the support of the government as nearly as possible, in proportion to their respective abilities.
2. The tax which each individual is bound to pay ought to be certain, and not arbitrary.
3. Every tax ought to be levied at the time, or in the manner which it is most likely to be convenient for the contributor to pay it.
4. Every tax ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible, over and above what it brings into the public treasury of the state.

Pope has summarised these "underlying features of a good tax system"<sup>6</sup> as: Equality; Certainty; Convenience of payment; Economy in collection. In the United Kingdom, it would appear that these original criteria are largely satisfied. In terms of equality, the progressive form of income taxation in this country allows this criterion to be satisfied. By contrast, equity suggests that the flat tax rate employed in the island of Jersey, for example, does not fulfil this principle. In terms of certainty, the fact that the full list

1 Ann Mumford expressed this view to a number of students during a lecture at *Queen Mary, University of London* in September 2012.

2 Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations: Volume V* (first published 1776, London: Methuen & Co., Ltd. 1904) V.2.24

3 Maurice Parry-Wingfield, 'The Chicken or the Egg' [2000] B.T.R. 597

4 James Edward Meade (and others), *The Structure and Reform of Direct Taxation* (Allen & Unwin, 1978) 20

5 John Stuart Mill, *Principles of Political Economy with some of their applications to social philosophy, Volume II* (D. Appleton & Co., 1894) 99, 401

6 Jeff Pope and Margaret McKerchar, 'Understanding Tax Morale and its Effect on Individual Taxpayer Compliance' [2011] B.T.R. 587





of taxes, and their breakdown, is available via the HMRC website satisfies this requirement. Furthermore, this suggests a high degree of transparency and public responsibility – “the authorities being accountable to the electorate at large”<sup>7</sup>; this is a matter which some believe is “one of the major attributes of a good tax system”<sup>8</sup>. With the existence of the PAYE system in the United Kingdom, it would appear to follow naturally that the UK scores highly in the final two criteria, as opposed to the United States, for example, who do not tax at source, leading to citizens spending a large amount of time and effort calculating how much they owe in tax. This latter practice shifts the burden of responsibility from the tax system to the taxpayer, which appears undesirable. *Prima facie*, it can be inferred that, according to the 18<sup>th</sup>-Century criteria, the UK has a “good tax system”..

However, the form of taxation employed in terms of income is progressive in nature. The “necessary evil” of progressive taxation has been described by Mill as “in fact, a graduated robbery”<sup>9</sup>. This appears to suggest that there is scope for improvement in this area. Nevertheless despite the perceived “small justice” in its existence, the fact that the vast majority of citizens pay it without complaint indicates that it is accepted as fair and necessary to achieve the “more equitable society”<sup>10</sup> that Mill was striving for.

### Meade Committee Report: Overview

The Meade Committee, in their 1976 publication, ‘*The Characteristics of a Good Tax Structure*’<sup>11</sup>, suggested six modern principles for determining what, in fact, a “good tax system” is. These are as follows:

1. Incentives and economic efficiency
2. Distributional Effects
3. International aspects
4. Simplicity and costs of administration and compliance
5. Flexibility and stability
6. Transitional problems

In order to ascertain whether the UK’s tax system is a “good” one according to modern criteria, it is necessary to discuss the scope and importance of each of these “modern” principles, and evaluate their relevance in the 21<sup>st</sup> century.

### Incentives and Economic Efficiency

The principle of economic efficiency, or neutrality<sup>12</sup>, simply refers to the extent to which a tax influences our choices; distortion should be kept to a minimum. “A tax is neutral if it avoids distortions of the market”<sup>13</sup>. The MCR suggests that a tax has the potential to cause various substitution effects on the economy. Many workers at the top of a tax bracket will merely take up more leisure time and work less rather than being taxed in the next tax bracket. The diagram below, referred to as ‘The Laffer curve’, analyses the effects.

7 James Edward Meade (and others), *The Structure and Reform of Direct Taxation* (Allen & Unwin, 1978) 18

8 Joseph Stiglitz, *Joseph Stiglitz and the World Bank: The Rebel Within* (first published 2001, Anthem Press 2001) 253

9 John Stuart Mill, *Principles of Political Economy with some of their applications to social philosophy, Volume II* (D. Appleton & Co., 1894) 99, 401

10 Takuo Dome, *The Political Economy of Public Finance in Britain 1767-1873* (first published 2004, Routledge 2004) 196

11 James Edward Meade (and others), *The Structure and Reform of Direct Taxation* (Allen & Unwin, 1978) 18

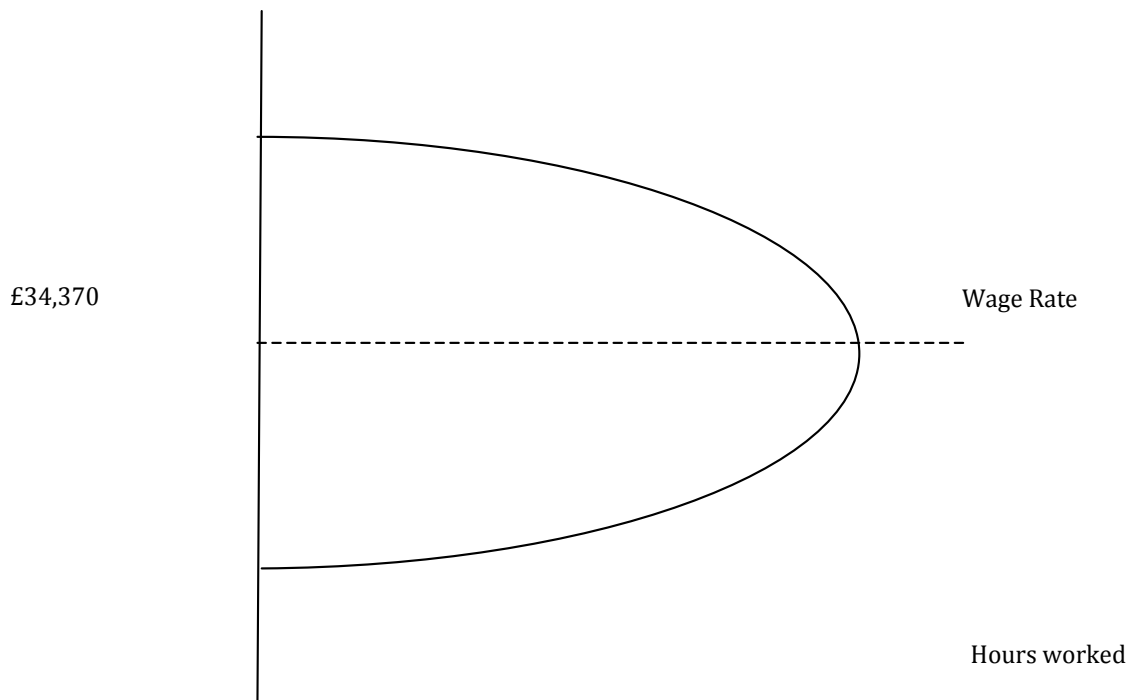
12 Groves (1948) 1 National Tax J 18; Bracewell Milnes [1976] B.T.R. 110

13 John Tiley, *Revenue Law: Introduction to UK Tax Law; Income Tax; Capital Gains Tax; Inheritance Tax* (first published 1976, Hart Publishing 2012) 11





Annual Income



Taking the current £0 - £34,370 tax bracket as an example, a worker reaching annual earnings of £34,370 – taxed at the basic rate of 20% in the UK – would, rather than accepting a promotion or working more hours, be more inclined to work at the same wage rate and take more leisure time, as opposed to being taxed at the higher rate of 40%.

In terms of specific goods, the “now defunct”<sup>14</sup> motor vehicle tax sometimes led to customers not buying a vehicle. An example of an indirect choice distortion arose during the government’s “Vehicle Scrappage Scheme” of 2009. Manufacturers were allowed to offset the amount of output tax on the sale of a car by the amount of VAT paid when scrapping a car. Although this may not have been the manufacturer’s primary concern, the tax breaks associated with participating in this scheme leading to the alleviation of the output tax may have subconsciously enticed them to participate.

However, it must be noted that a system may consciously choose to distort people’s choices. An illustration of this occurrence is the Congestion Charge, employed to discourage road users from driving in Inner London during the week. The principle of neutrality simply asserts that all distortions should be conscious and so subject to justification through the political process.<sup>15</sup>

### Distributional Effects

Any system of taxes is bound to have distributional effects.<sup>16</sup> A good tax system must be judged according to horizontal equity (or symmetry) as well as vertical distribution. Horizontal equity simply suggests that two people earning the same amount should be taxed the same amount. Although this form of symmetry is “not a natural state of affairs”<sup>17</sup>, Tiley opines that its “absence... may create opportunities for arbitrage”<sup>18</sup>.

<sup>14</sup> Ibid.

<sup>15</sup> John Tiley, *Revenue Law: Introduction to UK Tax Law; Income Tax; Capital Gains Tax; Inheritance Tax* (first published 1976, Hart Publishing 2012) 12

<sup>16</sup> James Edward Meade (and others), *The Structure and Reform of Direct Taxation* (Allen & Unwin, 1978) 12

<sup>17</sup> John Tiley, *Revenue Law: Introduction to UK Tax Law; Income Tax; Capital Gains Tax; Inheritance Tax* (first published 1976, Hart Publishing 2012) 14

<sup>18</sup> Ibid., 13



Adam Smith is not the only academic to have recognised the need to avoid arbitrage. Further, Tiley<sup>19</sup> regards equity as important for two reasons. Firstly, because the moral view is that it is right and proper; in the same way that equality before the law is regarded as right and proper. Secondly, due to the pragmatic view that if a system is believed to be fair and equal, taxpayers will be more willing to comply with it.

In terms of pragmatism, the traditional adage “an old tax is a good tax”<sup>20</sup> is also of relevance. Any introduction of a new tax which treats people differently according to how much money they make will be seen as inequitable until it becomes established; it may follow that ‘a new tax is an unfair tax’ and there is likely to be relatively low compliance until it becomes widely accepted. This may explain the rationale behind the recent rejection of George Osborn (the Chancellor of the Exchequer)’s mansion tax; a tax that would increase in accordance with a higher value of property. These points demonstrate the reasoning behind the inclusion of this principle.

However, it must be stated that there will inevitably be a clash between economic efficiency, which requires low marginal tax rates, and vertical distribution which requires high average tax rates on the rich<sup>21</sup>. Nevertheless, it could be argued that it is unlikely that this clash is still as relevant today. At the time of writing the report, Margaret Thatcher’s conservative government was in power, and there was more inequality in society. Furthermore, this criterion will not have been in favour with economists, who may view redistribution as unnatural and contrary to the usual free market forces.

### International Aspects

“[T]he more intimate and free are the international economic and financial relationships, the more important it becomes for national governments concerned not to get too far out of step in their general fiscal systems”<sup>22</sup>. This characteristic merely suggests that respect and attention has to be had to the wider international implications of tax decisions, as opposed to legislating purely intrinsically.

If a country that conducts in international trading does not take international aspects into account, there may be negative effects on their economy. There is evidence that complexity and uncertainty in the tax systems of new states joining the European Union (EU) have had marked deterrent effects on attracting foreign direct investment<sup>23</sup>, a form of investment which tends to improve a country’s GDP (Gross Domestic Product). With the increasing economic integration of the EU towards a fully single market, and the increasing number of member states within its scope, the importance of an internationally-based mind-set has become even more relevant for tax lawyers and accountants of late.

### Flexibility and Stability

The MCR believed that a “good tax system” should be flexible for two purposes. For economic reasons, the use of fiscal policy, in addition to monetary policy, is essential for stimulation of the UK’s national economy; the tax system has to be able to adjust in accordance with the economic cycle. Secondly, for political reasons, there must be a possibility of changes of emphasis in economic policy as one government succeeds another. The UK government’s wish to take advantage of improving economic conditions and become the most competitive tax system in the G20 will only be achievable if our tax system can adapt in time; before the conditions become less favourable again. This flexibility must be offset against the need for stability; there will always be a clash between these two matters in any matter to be determined by political discourse.

### Transitional Problems

This characteristic refers to the ease with which any proposed changes to the tax system could be implemented<sup>24</sup>. If the potential costs of change outweigh the potential gains, it is unlikely that it will be

<sup>19</sup> Ibid., 11

<sup>20</sup> Trevor Baldwin, ‘Taxation Compliance Costs – Implications for the Small Business’ [1989] B.T.R. 328

<sup>21</sup> James Edward Meade (and others), *The Structure and Reform of Direct Taxation* (Allen & Unwin, 1978) 12

<sup>22</sup> Ibid., 17

<sup>23</sup> Edmiston, et al (2003) 24 Fiscal Studies 341-60

<sup>24</sup> James Edward Meade (and others), *The Structure and Reform of Direct Taxation* (Allen & Unwin, 1978) 22



very logical to make these alterations. There will also be debate as to whether these changes should be implemented gradually or via a major upheaval. This characteristic may discourage a government from making any change whatsoever, and therefore it could be argued that this is the most significant aspect.

### **Simplicity and Costs of Administration and Compliance**

“A good tax system should... be coherent, simple and straightforward”<sup>25</sup>. This is said to be achieved via low costs of administration and compliance. Administrative costs refer to the costs suffered by the HMRC in collecting taxes and managing the tax system. Compliance costs refer to the costs suffered – usually by businesses – in working out how much is owed in tax. The reason why I am considering the fourth principle last is due to my belief that far more attention should be paid to compliance costs.

In terms of administrative costs, a survey completed in 2010 titled ‘*Tax Administration in OECD*’<sup>26</sup> discovered that administrative costs in the UK are only 0.2p lower than in 1958. This calls for concern, considering conscious effort has been made to lower administrative costs as they are believed to be too high. The most likely way that this will be achieved in the UK is via a simplification of the PAYE system, yet, this will only be achieved by putting more money into the system, either via an increase in the budget deficit or, controversially, via an increase in taxation.

However, surveys have shown that the costs of compliance have recently been several times higher than administrative costs<sup>27</sup>. Compliance costs are regressive and create resentment<sup>28</sup>; they are the primary concern and should always be less than administrative costs as they fall hard on small businesses. The rationale for administrative costs traditionally being focussed on was described in the report as follows<sup>29</sup>:

1. Administrative costs are met from taxation, whereas compliance costs fall on the private taxpayer and can, therefore, be markedly regressive.
2. Compliance costs are more likely to be resented by taxpayers.
3. Administrative costs are easier to ascertain and more open to public scrutiny.

Nevertheless, the issue of resentment is a significant one, and some critics believe that it is enough reason to give more attention to keeping compliance costs down. “If one employs an accountant to prove to the Revenue that no capital gains tax is due, should one be glad to have a nil tax liability, or cross because one has had to pay to establish it”<sup>30</sup>? “Alternatively, someone who is about to decide whether to set up his own business, or accept a salaried position in a big company, may let his choice be influenced by the consideration that in the former case his costs of tax compliance... are likely to be higher”<sup>31</sup>. A regular occurrence of this hypothetical may, as well as distorting our choices, lead to adverse effects on the economy as a result of the loss of potential increased competition between businesses.

### **Tax Avoidance and Evasion**

The largest adverse effect to the economy which could be said to stem from high compliance costs comes in the form of tax avoidance and evasion. A tax “must be acceptable to the public”<sup>32</sup>; otherwise people simply will not comply with it. High compliance costs can lead to an occurrence of both of these issues, and their existence, may cause an otherwise “good tax system” to be entirely compromised.

There is a difference between tax avoidance and tax evasion. Tax evasion is illegal and refers to a failure to pay a tax at all when it is due. Tax avoidance is legal, and refers to exploiting loopholes in the tax system;

25 Ibid., 18

26 Forum on Tax Administration ‘Tax Administration in OECD countries and selected Non-OECD countries: Comparative Information Series’ (Centre for Tax Policy and Administration, 3 March 2011) <<http://www.oecd.org/ctp/taxadministration/47228941.pdf>> accessed 1 February 2013

27 Chris Evans ‘Counting the costs of taxation: an exploration of recent developments’ (Institute for Financial Studies) <[www.ifs.org.uk/mirleesreview/reports/evans\\_lse.doc](http://www.ifs.org.uk/mirleesreview/reports/evans_lse.doc)> accessed 1 February 2013; Cedric Sandford (ed), *Tax Compliance Costs Measurement and Policy* (Fiscal Publications, 1995)

28 Ibid.

29 James Edward Meade (and others), *The Structure and Reform of Direct Taxation* (Allen & Unwin, 1978) 21

30 John Tiley, *Revenue Law: Introduction to UK Tax Law; Income Tax; Capital Gains Tax; Inheritance Tax* (first published 1976, Hart Publishing 2012) 13

31 Agnar Sandmo, ‘The theory of tax evasion: a retrospective view’ [2005] 4 National Tax

32 James Edward Meade (and others), *The Structure and Reform of Direct Taxation* (Allen & Unwin, 1978) 19



perhaps by disguising income as capital. Many people have difficulties in seeing the difference between evasion and avoidance from a moral point of view<sup>33</sup>. The prevalence of tax evasion may depend upon the individual taxpayer's perception of others; the more widespread evasion is, the more socially acceptable it may become. There is a very real possibility that a good tax system could fail merely due to the popularity of tax evasion stemming from high compliance costs.

### **Conclusion**

In conclusion, the criteria for a good tax system have not changed too significantly since the inception of Adam Smith's Canons of taxation. The United Kingdom heavily satisfies these initial criteria. However, the MCR has developed modern principles from these original canons, taking into account changes in the economy, including the need to take into account international aspects. As stated in the much-referred-to Meade Committee Report, it must be noted that where these various characteristics conflict, it is an essential function of the political process to determine how much weight to give to each of them. In my view, for a tax system to succeed, more attention must be given to alleviating compliance costs, in order to tackle the often-neglected, yet important, issues of tax evasion and tax avoidance.

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33 Agnar Sandmo, 'The theory of tax evasion: a retrospective view' [2005] 4 National Tax J



**The future of Maltese tax  
litigation after  
*John Geranzi Ltd.***

***v***

***Commissioner of Inland  
Revenue***

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## Introduction

The notion of fundamental human rights was first enunciated on an international scale in the 1948 United Nations Universal Declaration of Human Rights, followed by the 1950 adoption of the Convention for Protection of Human Rights and Fundamental Freedoms.<sup>1</sup> At first glance, the link between taxation and such rights is not as explicit and obvious as is the case in the realm of other branches of law.<sup>2</sup> However, a deeper examination would inevitably lead one to notice ‘une ambivalence inhérente à la relation entre l’impôt et les droits de l’homme’.<sup>3</sup>

Maltese legislation embodies the fundamental freedoms found in the ECHR on a number of levels. Firstly, the Maltese Constitution<sup>4</sup> in Articles 32 – 47 incorporates a number of fundamental and inalienable rights. These include the right to property,<sup>5</sup> the right to protection from inhuman and degrading treatment,<sup>6</sup> the right to protection from forced labour,<sup>7</sup> the right to liberty and security of person,<sup>8</sup> the right to a fair hearing,<sup>9</sup> the right to private and family life,<sup>10</sup> the right to freedom of association,<sup>11</sup> the right to an effective remedy<sup>12</sup> and the right to protection from discrimination.<sup>13</sup> Such rights may be invoked and enforced via the two mechanisms set out in Article 46 of the Constitution, namely the reference procedure<sup>14</sup> or the application procedure.<sup>15</sup>

On a second and overlapping tier, there is the protection of such rights on a European level.<sup>16</sup> Through Act XIV of 1987 which enacted the European Convention Act,<sup>17</sup> the Maltese legislator transposed the provisions of the ECHR into Maltese legislation, which are now found in the abovementioned articles of the Constitution. Furthermore, due to Malta’s membership of the European Union (hereinafter ‘EU’), the Charter of Fundamental Human Rights<sup>18</sup> is also part of Maltese law, due to it having the same force of law as any other EU Treaty with the 2009 ratification of the Lisbon Treaty.

## John Geranzi Limited v Commissioner of Inland Revenue: Background

1 Now known as the European Convention on Human Rights (hereinafter ‘ECHR’), amended last by Protocol number 14 which entered into force on 1 June 2010. The full text is available at <[http://www.echr.coe.int/NR/rdononlyres/D5CC24A7-DC13-4318-B457-5C9014916D7A/0/Convention\\_ENG.pdf](http://www.echr.coe.int/NR/rdononlyres/D5CC24A7-DC13-4318-B457-5C9014916D7A/0/Convention_ENG.pdf)>.

2 Such as in the field of criminal law for example.

3 ‘An inherent ambivalence between taxation and human rights.’ Eric Allen Engle, *Human Rights and Taxation (Les Droits de l’Homme et l’Impôt)* (22 September 2008) <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1271870](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1271870)>.

4 <<http://www.justiceservices.gov.mt/DownloadDocument.aspx?app=lom&itemid=8566&l=1>>.

5 Art 1 of the First Protocol of the ECHR (n 1).

6 Art 3 of the First Protocol of the ECHR (n 1).

7 Art 4 of the First Protocol of the ECHR (n 1).

8 Art 5 of the First Protocol of the ECHR (n 1).

9 Art 6 of the First Protocol of the ECHR (n 1).

10 Art 8 of the First Protocol of the ECHR (n 1).

11 Art 11 of the First Protocol of the ECHR (n 1).

12 Art 13 of the First Protocol of the ECHR (n 1).

13 Art 14 of the First Protocol of the ECHR (n 1).

14 As per art 46 (3) of the Constitution of Malta:

If in any proceedings in any court other than the Civil Court, First Hall, or the Constitutional Court any question arises as to the contravention of any of the provisions of the said [arts] 33 to 45 (inclusive), that court shall refer the question to the Civil Court, First Hall, unless in its opinion the raising of the question is merely frivolous or vexatious [...].

15 As per art 46 (1) of the Constitution of Malta:

[...] any person who alleges that any of the provisions of [art] 33 to 45 (inclusive) of this Constitution has been, is being or is likely to be contravened in relation to him, or such other person as the Civil Court, First Hall, in Malta may appoint at the instance of any person who so alleges, may, [...] apply to the Civil Court, First Hall, for redress.

16 As explained in Robert Attard, *An Introduction to Income Tax Theory* (Agenda Publishers 2005) 25, Malta became a signatory to the ECHR and its accompanying First Protocol on 23 January 1967. In addition, on 1 May 1987 Malta formally recognised the compulsory jurisdiction of the European Court of Human Rights (hereinafter ‘ECtHR’), and the door was opened for the European Commission of Human Rights to ‘receive Maltese petitions on breaches of civil rights’.

17 Chapter 319 of the Laws of Malta.

18 2000/C 364/01.



The Constitutional Court judgment<sup>19</sup> of *John Geranzi Limited v Commissioner of Inland Revenue* et<sup>20</sup> brought a final end to over thirty years of dispute between this Maltese registered company<sup>21</sup> and the Director General of Income Tax, previously known as Commissioner of Inland Revenue (hereinafter 'CIR').

John Geranzi Limited was registered with the Registry of Companies in June 1966. On 25 September 1980, with respect to the Year of Assessment 1977, the CIR furnished the plaintiff company with an additional tax assessment totaling Lm 7912.<sup>22</sup> The reason for such additional tax assessment and subsequent Letter of Refusal is that the income quantified in the original self-assessment for the Year of Assessment 1977 and following years was too low to be deemed acceptable, leaving the CIR with no choice but to issue a revised estimate featuring additional tax as is provided for in Article 31 of the Income Tax Management Act.<sup>23</sup>

As was to be expected, the plaintiff company actively contested such assessment within the stipulated time period. However, it was not until twenty-seven years later that the defendant entity reverted back to John Geranzi Limited with a Letter of Refusal, reinforcing its stance regarding the imposition of such additional tax. It was only then that the plaintiff company had access to the Board of Special Commissioners (hereinafter 'BSC') to make its claim heard.<sup>24</sup>

The plaintiff company filed an application for Appeal for this Letter of Refusal on 7 September 2007, with the case being scheduled for hearing before the BSC in 2008.

### Proceedings before the BSC

During the hearing of the case before the Board, it emerged starkly that the great delay in processing and deciding upon the plaintiff's Letter of Objection by the CIR prejudiced and violated the former's fundamental right to a fair trial. John Geranzi Limited pleaded with the Board to apply the provisions enunciated by the ECtHR regarding the shifting of the burden of proof in cases of additional tax. However, on 22 December 2008, in Case 29 of 2007, the BSC rejected a number of the plaintiff's arguments based on 'tax not in dispute' and pleas of prescription.

However, the crux of the case, which became more evident with each Board sitting held, centered upon the im-

19 The Maltese Constitutional Court is one of the three superior civil courts within the jurisdiction of Malta. Its jurisdiction is outlined in art 95 (2) of the Constitution of Malta. Broadly, this Court enjoys original jurisdiction (at first instance) with regard to its power to hear and decide upon any reference made to it regarding the voting at general elections and the election of members to the House of Representatives, such as whether such members have been validly elected thereto. It also sits as a Court of Appeal (at second instance) when entertaining appeals from decisions of the First Hall of the Civil Court sitting in its Constitutional jurisdiction under art 46 of the Constitution of Malta (please see n 6 and 7) being human rights actions instituted to invoke the protection of the fundamental human rights embodied in arts 32 – 47 of the Constitution of Malta; appeals from decisions regarding the interpretation of the Constitution as well as the appeals from decisions regarding the validity of laws, in both cases from provisions and laws not falling under art 46.

20 Constitutional Court; 30/11/2012; 22/2009/1 <<http://www.justiceservices.gov.mt/courtservices/Judgements/search.aspx?func=all>>.

21 Bearing registration number C 506.

22 Today equivalent to €18,430 or £15,915.98.

23 Chapter 372 of the Laws of Malta.

24 Previously, the local Tribunal which was competent to hear and decide appeals against an allegedly excessive income tax assessment issued by the CIR was the BSC, established under art 34 (now repealed) of the Income Tax Management Act, (n 23). Due to the plethora of individual tribunals which existed in Malta, in 2009, this Tribunal, together with a number of other Tribunals, such as the Transport Appeals Board, were consolidated and merged into the Administrative Review Tribunal, set up under the Administrative Justice Act, Chapter 490 of the Laws of Malta. Today, appeals from excessive income tax assessments issued by the CIR are now entertained by the Administrative Review Tribunal.



position of an additional tax amounting to Lm 1910<sup>25</sup> by the CIR on the plaintiff company, which according to the latter, was equivalent to a 'criminal charge'. In proceedings before the BSC, the plaintiff company cited the European case of *Paykar v Armenia*,<sup>26</sup> in which the Strasbourg Court found there to be a violation of the right to a fair hearing as enunciated in Article 6 (1) ECHR due to the imposition of excessively high 'state fees'.

The BSC noted that with respect to the terminology 'criminal' and 'criminal charge', the placing of such terms in inverted commas indicated that they were being used outside of their normal meaning.

Furthermore, the BSC too referred to the *Paykar* case,<sup>27</sup> which in turn drew knowledge from the *Ferrazzini v Italy* judgment.<sup>28</sup> Namely, recourse was made to the sentiments of the European judgments wherein they referred to the *Engel* criteria<sup>29</sup> when determining whether an offence was indeed 'criminal', being 'the legal classification of the offence in domestic law, the nature of the offence and the degree of severity of the possible penalty'.<sup>30</sup>

The European judges were careful not to attribute an autonomous meaning to the word 'criminal' as found in the ECHR which would result in it having a uniform and automatic meaning in every jurisdiction and in every context in which it is used. The BSC observed that 'additional tax' is imposed by Maltese legislation when the taxpayer does not send in a tax return as required, when such return is submitted late, when the taxpayer does not declare in a sufficiently clear manner the income earned, or else attempts to evade tax in any manner whatsoever. According to the BSC, this practice can in no way be equated to a criminal act in the Maltese domestic legal framework. The BSC also held that the classification and nature of the 'offence' of an illegitimately low declaration of income under Maltese law is a fiscal and not a criminal offence.

Lastly, the BSC also held for the CIR on two other points: the BSC refused to accept the plaintiff's argument that the calculation of the additional tax by the CIR was incorrect and unjust. Secondly, the BSC stated that the plaintiff was incorrect in invoking Article 46 (3) of the Constitution<sup>31</sup> by obliging the BSC to refer the case to the Constitutional Court. In fact, it was held that this is a question of appeal under the provisions of Article 35 ITMA,<sup>32</sup> namely that the alleged prejudice suffered by the plaintiff company due to such assessment was to be appealed to the BSC within thirty days after the date of service of the CIR's notice of refusal.

### Proceedings before the Court of Appeal, Inferior Jurisdiction

The plaintiff, deeply aggrieved by the fact that the BSC re-confirmed the re-assessment and Letter of Refusal issued by the CIR, appealed the Board's decision in front of the Court of Appeal (hereinafter 'COA') sitting in its inferior jurisdiction.<sup>33</sup> The appeal lodged by the company rested upon two fundamental notions: first, the twenty-seven year time lapse between the assessment sent in by the company and the issuing of a Letter of

25 Today equivalent to €4449.10 or £8951.67.

26 App no 21638/03 (ECtHR, 2 June 2008).

27 *ibid*.

28 App no 44759/98 (ECtHR, 12 July 2001).

29 As enunciated in *Engel and others v the Netherlands* App no 5100/71; 5101/71; 5102/71; 5354/72; 5370/72 (ECtHR, 8 June 1976).

30 *John Geranzi Limited v CIR et al* (First Hall, Civil Court; (Const.) 10/05/2012; 22/2009) 12.

31 (n 14).

32 As it was included in the law by Act XVIII of 1994.

33 Appeals from decisions of the BSC emanating from a provision of the Income Tax Act, Chapter 123 of the Laws of Malta as well as certain provisions emanating from the Income Tax Management Act, Chapter 372 of the Laws of Malta, (such as the provision at hand, where the total amount of tax, additional tax, fines and interest in dispute at the time when the appeal was lodged before the Administrative Review Tribunal or the Board of Special Commissioners, as the case may be, is less than one million and one hundred and sixty-five thousand euro (€1,165,000)) are to be heard by the Court of Appeal, sitting in its Inferior Jurisdiction. As per art 41 (6) of the Code of Organisation and Civil Procedure, Chapter 12 of the Laws of Malta

for the purposes of such appeals, the Court of Appeal shall be constituted by one of its members only, and any one of the judges, appointed by the President of Malta to sit for the hearing of such appeals, shall be deemed to be a member of such court. The Court of Appeal as constituted under this sub[art] may also be referred to as the Court of Appeal (Inferior Jurisdiction).



Refusal by the CIR meant that the plaintiff was not afforded the right to a fair hearing within a reasonable time and this jeopardised the possibility for the taxpayer to defend itself adequately. Additionally, the fact that the Board refused to implement the shifting of the burden of proof according to the standard in criminal cases as enunciated by the ECtHR further resulted in a violation of the abovementioned right.

In turn, the COA passed the case and above arguments to the First Hall of the Civil Court, sitting in its Constitutional jurisdiction.<sup>34</sup>

### **Proceedings before the First Hall Civil Court, Constitutional Jurisdiction<sup>35</sup>**

#### ***Violation of the Right to a Fair Hearing within a Reasonable Time***

The plaintiff company argued vehemently that the fact that an appeal regarding a 1977 assessment was being heard in 2008 definitely amounted to a violation of Article 6 of the ECHR and Article 39 of the Maltese Constitution. This thirty-one year lapse left the plaintiff company in no man's land with regard to its defence and its overall short-term and long-term operations.

Furthermore, this extended period of time severely prejudiced the quality of defence which the plaintiff could put forward before the CIR. The directors and persons working for the company in 1977 were certainly not the same individuals who were doing so in 2008. Documents go missing with the passage of time and with a change in personnel over the years, this timeframe meant that certain documents which could aid the correct evaluation of the tax estimate were no longer available.

Notwithstanding pronouncements by the COA holding that if more than nine years have passed, a person may not suffer any consequences if after this period of time such individual has not kept records which were held previously, the BSC still refused to decide in the plaintiff's favour, resulting in such violation and such appeal.

#### **Lack of shifting of the burden of proof**

John Geranzi Limited argued that Article 6 was violated from a second angle due to the fact that the BSC refused to apply the shifting of the burden of proof in such a matter dealing with an additional tax amounting to 31.8% over and above the original tax amount, as has been held previously by the ECtHR.<sup>36</sup>

This notion regarding the imposition of an exceptionally high amount of additional tax being equal to a penalty and therefore falling within the protection of criminal law safeguards was confirmed in *King v United Kingdom*.<sup>37</sup> While this case was not referred to by the Maltese Court in its judgment, the European judges therein explained clearly that 'the procedures which imposed, in this case, penalties of a considerable size [80% of the tax due] attract the guarantees of Article 6 (1) as concerning the determination of a 'criminal charge'.<sup>38</sup>

34 (n 19). For a more detailed explanation regarding the issue of Constitutional jurisdiction, please see the partial judgment *John Geranzi Limited v CIR et* (First Hall, Civil Court (Const.); 20/01/2011; 22/2009) <<http://www.justiceservices.gov.mt/courtservices/Judgements/search.aspx?func=all>>.

35 (n 30).

36 For further information regarding this point, refer to *Bendenoun v France* App no 12547/86 (ECtHR, 24 February 1994); *JJ v The Netherlands* App no 21351/93 (ECtHR, 27 March 1998); *HWK v Switzerland* App no 26453/95 (ECtHR, 10 September 1997); *Stork v Germany* App no 38033/02 (ECtHR, 13 July 2006).

37 App no 13881/02 (ECtHR, 17 February 2004) <<http://echr.ketse.com/doc/13881.02-en-20040217/view/>>.

38 *ibid*.



John Geranzi Limited's legal team referred to the European judgment of *Hannu Lehtinen v Finland*,<sup>39</sup> wherein the Court held that 'Article 6 is applicable under its criminal head to tax surcharge proceedings.'<sup>40</sup> For this reason, it was argued that when dealing with cases of additional tax, the Court must adhere to the norms and practices related to the individual's rights normally associated with criminal cases, including the right to silence, the presumption of innocence until proven guilty and the shifting of the burden of proof on the plaintiff. It was emphasised that in the current case, the imposition of such an amount of additional tax was tantamount to a criminal charge; therefore all the rights and proceedings pertinent to a criminal case were applicable here.

### ***Judgment***

The Court held unequivocally that there indeed was a violation of the company's fundamental right to a fair hearing within a reasonable time due to the unjustified and unreasonable length of time which was allowed to pass until the CIR issued his Letter of Refusal. The Court also agreed with the plaintiff in its arguments that such passage of time prejudiced the latter's ability to defend itself adequately in the face of such refusal.

Regarding the issue of the shifting of the burden of proof which should have occurred, the Court held that the CIR was not responsible for this deficiency as it fell completely under the remit of the BSC, unrelated to the CIR's competence.

The Court concluded that it was impossible for the decision propounded by the BSC to be revoked as the plaintiff had pleaded, as the CIR was in no way answerable for the BSC's decisions. Therefore, the awarding of compensatory damages to the plaintiff payable by the CIR was the only viable option in this case.

Taking into consideration the length of time which was taken for the Letter of Refusal to be issued and the time for which this issue has been pending, the Court computed the damages to be awarded to the plaintiff at €30,000. Court expenses were divided between the parties.

### **Proceedings before the Constitutional Court<sup>41</sup>**

The above judgment was subsequently appealed by both parties. The plaintiff's appeal was based on three points: firstly because the previous judgment decided that the Prime Minister and the Attorney General were non-suited in the case at hand, secondly because the previous Court opted not to repeal the BSC's decision, and thirdly because Court expenses were divided between the parties.

Conversely, the CIR's appeal was focused on that part of the judgment which deemed the CIR to have violated the company's fundamental human right of a fair hearing. The appeal was also based on the liquidation of €30,000 worth of compensatory damages to the plaintiff.

### ***Judgment***

Agreeing with the decision and *raison d'être* of its predecessor, the Court categorically held that no matter what the reasons were for the twenty-seven year delay in issuing a Letter of Refusal, such tardiness could in no way be justified. Even the fact that the plaintiff may have played a part in this delay is not a valid excuse. The Court stressed that Government entities are to proceed efficiently and without delay, and if the CIR observed that the plaintiff company was not co-operating with the procedure at hand, it should have promptly

<sup>39</sup> App no 32993/02 (ECtHR, 22 July 2008).

<sup>40</sup> (n 30) 10.

<sup>41</sup> (n 20).





issued a Letter of Refusal. This delay not only prejudiced the plaintiff's access to judicial organs, but it also consequently violated its right to a fair hearing within a reasonable time.

This is intrinsically linked to the fact that the plaintiff was severely disabled in its ability to defend itself adequately before the BSC and the subsequent courts. Again, the Court agreed with its predecessor in attributing fault for such occurrence to the CIR's delay.

With regard to the question whether the imposition of additional tax amounts to a 'criminal charge', the Court reaffirmed that all involved terms retain an autonomous and independent meaning, and such additional tax is indeed a penalty, requiring the taxpayer to have free access to the courts and tribunal.

The Court decided to deny the plaintiff's appeal against the previous Court's decision that the Prime Minister is non-suited to the case at hand; however, it opted to overturn the decision with regard to the Attorney General and indeed reinstated such individual as a party to the case.<sup>42</sup>

Furthermore, when deciding how to compensate the taxpayer, the Court decided not only to repeal the BSC decision, but also to revoke the CIR's decision not to accept John Geranzi Limited's objection of the estimate issued by the CIR ex officio. In this way, there would be a restitutio in integrum of some sorts and the plaintiff would be placed in the same position had such objection been accepted twenty-seven years prior.

Somewhat controversially, the Court held that there was no need to award such compensatory damages as the previous Court had done. In paragraph thirty-three of the judgment,<sup>43</sup> it is proclaimed that the aim behind such an action is not for the plaintiff to be given some kind of advantage, but to be reinstated to its previous position before the injustice was done. Therefore, instead of ordering the payment of compensation, it is sufficient if there is a set-off between the moral compensation due and any interest payable on the repayment of tax after so many years. The Court held that the fact that the plaintiff retained the tax which it was due to pay to the CIR all these years was sufficient compensation to rectify the violation of its rights.

Lastly, with regard to court expenses, the Court modified the apportionment of such expenses in favour of the plaintiff.

### **Conclusion: Maltese tax litigation following John Geranzi Limited v CIR et**

While the application of the ECHR and fundamental human rights in the realm of taxation law has previously been confirmed in the local court room, the John Geranzi case introduces a novel aspect to this relationship. For the first time, it has been held by a Maltese court that the imposition of an additional tax is indeed tantamount to the imposition of a criminal charge rendering applicable all the notions and rights previously associated with criminal cases. Therefore, from being a purely civil action, such taxation cases are now transported into the realm of criminal law.

In so doing, the author contends that the Court extended what was held by the Constitutional Court in the case *Joseph Busuttil noe v Prime Minister*<sup>44</sup> wherein it was stated that 'fiscal provisions that incorporate a penal element that 'determine a criminal charge' are penal laws for all intents and purposes [...]'<sup>45</sup> to include also

<sup>42</sup> As per art 181B of the Code of Organisation and Civil Procedure, Chapter 12 of the Laws of Malta, '[t]he Attorney General shall represent Government in all judicial acts and actions which owing to the nature of the claim may not be directed against one or more heads of other government departments.'

<sup>43</sup> (n 20).

<sup>44</sup> (20/07/1994) as cited in Attard (n 16) 46.

<sup>45</sup> Attard (n 16) 46.



the imposition of additional tax within such class of fiscal provisions falling under the realm of criminal law.

As enunciated by Attard,<sup>46</sup> '[u]ndoubtedly, when a dispute is of a penal nature all the safeguards of fundamental human rights apply but when a dispute is of a 'fiscal nature' 'the public law character of the obligations concerned predominates' and the said safeguards do not apply.'<sup>47</sup>

This 'transportation' into the criminal law sphere turns the tables completely; not only is the taxpayer afforded all the rights synonymous with a criminal trial: the right to silence, the right to legal representation, and the right to be presumed innocent until proven guilty, but the 'prosecution' in such cases, is burdened, so to speak, with the same responsibilities and duties as the Attorney General's Office is when prosecuting before the competent Criminal Court. These include the fact that the burden of proof is increased from a balance of probabilities as is found in the Civil Law sphere, to the more onerous level of proof beyond reasonable doubt together with the shifting of the burden of proof away from the taxpayer.

As Philip Baker commented following the Ferrazzini case,

[a]t least for the present, the taxpayer in ordinary tax litigation has no right to a fair trial under Article 6 of the Convention. In the absence of any equivalent protections under the constitutional or administrative law of the country concerned, the taxpayer has: no right to a determination within a reasonable time; no right of access to a court; no right to a public hearing; no right to an independent and impartial tribunal [...], no right to the protections regarding publicity and public access contained in Article 6.<sup>48</sup>

Therefore, in its November 2012 judgment the Court has changed the reality described by Baker above and solidified the categorisation of the imposition of additional as a 'criminal charge', rendering all future disputes containing such an aspect criminal actions and affording the taxpayer the same benefits and rights as any other offender charged with the most heinous of crimes. Although the Maltese judicial system does not follow the theory of precedent as found in the United Kingdom, the author contends that such a lucid and comprehensive judgment is likely to prove to be rather difficult to divert from, at least in a radical manner. Now, taxpayers appearing before any of the competent judicial organs are not presumed guilty until proven innocent yet are afforded the full benefits of a judicial system which reflects Malta's position as a safeguard of human rights.

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<sup>46</sup> *ibid.*

<sup>47</sup> *Joseph Busuttil noe v Prime Minister* (n 41) as cited in Attard (n 16) 46.

<sup>48</sup> Philip Baker, *The Decision in Ferrazzini: Time to Reconsider the Application of the European Convention on Human Rights to Tax Matters* <[http://www.taxbar.com/documents/Ferrazzini\\_Philip\\_Baker.pdf](http://www.taxbar.com/documents/Ferrazzini_Philip_Baker.pdf)>.



# **Absence of Precedent in Investment Arbitration: A missed Opportunity to Clarify Standards of Protection**

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## Abstract

*Entrepreneurs<sup>1</sup> who invest capital in a business face financial risks especially when they invest in a foreign country where there is no regulatory and economic stability, so they generally avoid investing in such countries. To attract foreign capital, states enter into Bilateral Investment Treaties (BITs), under which a reasonable level of protection is promised to investors. In this context, a reasonable level of protection includes the state's promise that it will not expropriate assets of the foreign investor, unless doing so is against their public policy. BITs also provide 'full protection and security', 'fair and equitable treatment', 'most favoured nation' and 'umbrella' clauses in order to afford further protection to investors.*

*However, investors frequently raise claims against host states, alleging that the host state has breached the standards of protection by expropriating their assets. In response to such claims, host states generally seek to justify expropriation on the basis of a change in the law, and they argue that this change was necessary for public policy reasons. This raises an important question: In what circumstances should the host state be held to have breached its standards of protection irrespective of their public policy defence?*

*There is no law of precedence in International Centre for Settlement of Disputes (ICSID) arbitration. Tribunals are not bound by the decisions of other tribunals, and they thus take different views in interpreting treaty provisions to make a decision. This position creates legal uncertainty: When a dispute arises between the foreign investor and host state, the question of how the tribunal will interpret the relevant BIT provisions cannot be answered with certainty. Despite many serious attempts on the part of the tribunals to bring certainty, conflicting arbitral decisions dominate this environment.*

## Introduction

Risk is inherent in conducting business. Through the eyes of the investors, investing abroad, however, poses additional challenges, for it is hard to foresee what the socio-economic, socio-political, legal and economic position of a foreign country might be in the future. These difficulties have much significance to the investor because having a lucrative business abroad depends upon the stability of the state and its legal framework for the protection of investors and their interests. It is vital for a foreign investor to know how a particular state will treat foreign investments in order to decide whether or not to invest in that state.<sup>2</sup> In order to attract foreign investors, host states offer BITs in which they make various concessions, such as undertaking fair and equitable treatment towards investors and forgoing their rights to expropriate.<sup>3</sup>

Nonetheless, anyone examining investment arbitration disputes in the last decade will see that host states were several times alleged to have breached their promises by changing the laws and regulations contrary to the relevant BITs. While such changes seem to result from the economic, political and environmental concerns of host states, they raise one further key question: In what circumstances do the exercise of state sovereignty amount to a breach of standards of protection?

On determining the liability of host states, ICSID tribunals and other tribunals have interpreted the provisions envisaged under the BITs. Given that there is no binding precedent in investment arbitration, the tribunals have not interpreted the key BITs provisions in the same way. Hence, their decisions on what constitutes 'just',

<sup>1</sup> Hereinafter referred to as 'investors'.

<sup>2</sup> See Annika Wythes, 'Investor-State Arbitrations: Can the "Fair and Equitable Treatment" Clause Consider International Human Rights Obligations?' (2010) 23(1) Leiden J Intl L 241, 246.

<sup>3</sup> See, for instance, Art. 1110 of the North American Free Trade Agreement.



'equitable', 'fair' and 'reasonable' cannot form a set of guidance for investors and host states.<sup>4</sup> Consequently, investors and host states are often left with no choice but to arbitrate their disputes to clarify a number of critical issues, such as deciding whether expropriation was justifiable.

This paper will examine the uncertainty surrounding the interpretation of the standards of protection under BITs. In this respect, it will analyse the landmark arbitration awards which sought to bring clarification to interpretation of BITs. It will be concluded that the lack of review mechanism and precedent prevent investors from predicting their substantial and procedural rights and obligations under the relevant BITs.

### 1) Interpretation of 'Fair and Equitable Treatment' provisions

In the face of arbitral decisions given in the last 20 years, no definitive meaning can be given to the 'fair and equitable treatment' ('FET') provisions. The main reason for this is that, in most BITs, there is a blanket obligation on the part of the state to treat investors fairly, without stating any measures, to ensure fair and equal treatment.<sup>5</sup> Consequently, BITs are usually not helpful for tribunals in deciding whether the FET provision was breached by the host state. Hence, the tribunals need to consider what constitutes 'fair' and 'equitable' under the circumstances of each case.

FET provisions have their roots in customary international law, which dictates that states should at least provide a minimum standard of treatment of aliens. As this is the case, some tribunals opted to view FET provisions as a mirror-image of the customary international law. Hence, in *Siemens A.G. v. The Argentine Republic*, the tribunal took the view that FET provisions need to be interpreted pursuant to customary law, despite the absence of a provision in BITs to that effect.<sup>6</sup> Similarly, in *S.D. Myers v. Canada*, the tribunal argued that 'fair and equitable treatment' should be interpreted 'in accordance with international law'.<sup>7</sup> On the interpretation of the FET provision stipulated under Article 1105 of NAFTA, the Free Trade Commission of NAFTA also decided that both FET and 'full protection of security' provisions must be interpreted in accordance with customary international law.<sup>8</sup>

A number of tribunals acknowledged that the rules of customary international law do not remain constant.<sup>9</sup> In so doing, they took the view that BITs provisions<sup>10</sup> and the factual circumstances of the case should be decisive.<sup>11</sup>

4 Christopher Brummer, 'Examining the Institutional Design of International Investment law: Insights from the Symposium on Transparency and Consistency in International Investment Law' in Karl P Sauvart (ed), *Appeals Mechanism in International Investment Disputes* (OUP 2008) 283; Domenico Di Pietro, 'The Use of Precedents in ICSID Arbitration: Regulatory or Certainty?' (2007) 10(3) *Intl Arb L Rev* 96, 103.

5 See, for instance, the German Model BIT and Swiss Model BIT.

6 *Siemens A.G. v. The Argentine Republic*, ICSID Case No. ARB/02/08, Award, 6 February 2007, para 291.

7 *S.D. Myers v. Government of Canada*, UNCITRAL (NAFTA) Partial Award (Nov. 13, 2000), para 262.

8 See Catherine Yannaca-Small, 'Fair and Equitable Treatment Standard: Recent Developments' in August Reinisch (ed), *Standards of Investment Protection* (OUP 2008) 114.

9 *Compania de Aguas del Aconquija S.A. and Vivendi Universal S.A. v. Argentine Republic*, ICSID Case No. ARB/97/3, Award, 20 August 2007, para 7.4.5; *Sempra Energy v. The Argentine Republic*, ICSID Case No. ARB/02/16, 28 September 2007, para 302; *Azurix v. Argentine Republic*, ICSID Case No. ARB/01/12, Award, 14 July 2006, para 361; *Mondev International Ltd. v. United States of America*, ICSID Case No. ARB(AF)/99/2, 11 October 2002, para 125; *Enron Corporation v. Argentina Republic*, ICSID Case No. ARB/01/3, para 257; *Tecnicas Medioambientales Tecmed, S.A. v. United Mexican States*, ICSID Case No. ARB(AF)/00/2, Award, 29 May 2003; *Pope & Talbot Inc. v. Canada*, NAFTA (UNCITRAL), Arbitration Proceeding, Interim Award, 26 June 2000.

10 See, generally, *ADF Group Inc. v. United States of America*, ICSID Case No. ARB(AF)/00/01, 1 August 2002. See also, *ADF Group Inc. v. United States of America*, ICSID Case No. ARB(AF)/00/1, Final Award, 9 January 2003, para 129.

11 See *Mondev* (n 9) para 127; *Saluka Investments BV v. The Czech Republic*, Partial Award, 17 March 2006, para 291; *Waste Management Inc. v. United Mexican States*, A/F/00/3, para 96.





In the leading *Neer* case, it was held that ‘the treatment of an alien... should amount to an outrage, to bad faith, to wilful neglect of duty, or to an insufficiency of governmental action so far short of international standards that every reasonable and impartial man would readily recognize its insufficiency’. Some tribunals departed from this approach.<sup>12</sup> Hence, following the decision in *Mondev International Limited v. United States of America*<sup>13</sup> and *ADF Group Inc. v. United States of America*,<sup>14</sup> the tribunal in *Waste Management v. United States of Mexico* took the view that FET provisions cannot be taken as tantamount to the ‘outrageous treatment’ stipulated in *Neer*.<sup>15</sup>

On determining how FET provisions must be interpreted, a number of tribunals took a liberal approach, which favours a flexible interpretation of FET provisions under the evolving customary law standards. The tribunal in *Waste Management* indicated a number of factors that are decisive in determining whether a FET provision is breached by a host state.<sup>16</sup> These factors include “discriminatory and arbitrary conducts by the host state, lack of due process and/or transparency on the part of the host state, exposure of the investor to “sectional or racial prejudice”, and “breach of representations made by the host state which were reasonably relied on by the claimant”. By the same token, while determining the ingredients of the FET standard in the context of denial of justice, the tribunals in *Loewen*, *Occidental* and *Gas Transmission Company* argued that the elements of ‘bad faith’ or ‘malicious intention’ do not need to be proven in order to establish the unfairness of the host state.<sup>17</sup>

In sharp contrast to the liberal approach, the tribunal in *Genin v. Estonia* held that there would be no breach of the FET standard, if it was not proven that the host state acted in bad faith.<sup>18</sup> In so doing, the tribunal in *Genin v. Estonia* refused to follow the rules of international law. This refusal also ran counter to Article 31(1) of the Vienna Convention on the Law of Treaties, which suggests the rules of international law should also be taken into account when interpreting treaties.<sup>19</sup>

## 2) Obligations of the host states on ‘Full protection and security’

The tribunals have also had varying approaches towards the interpretation of full protection and security provisions. The case law demonstrates that the tribunals have either adhered to the level of standard envisaged under the international customary law or have gone beyond those limits. One of the foremost cases that fall into the former category is *Saluka v. Czech Republic*.<sup>20</sup> In this case, the tribunal took the view that full

12 *USA v. United Mexican States*, decision of the General Claims Commission, United States Mexico, 15 October 1926, reproduced in the American Journal of International Law 1927, pp.555, 556; 3 ILR 213, quoted in *Mondev* (n 9) para 114.

13 *Mondev* (n 9).

14 *ADF Group Inc.*, 1 August 2002 (n 10).

15 See A/F/00/3, para 93.

16 *Waste Management Inc.* (n 11) paras 98-99.

17 *Loewen Group, Inc. v. United States of America*, Award, 26 June 2003, Case No ARB(AF)/98/3, para 132; *Occidental (OPEC) v. Ecuador*, LCIA No. UN 3467, Award, 1 July 2004; *CMS Gas Transmission Company v. Argentine Republic*, ICSID Case No. ARB/01/8, Award, 12 May 2005, quoted in *Yannaca-Small* (n 8) at 119, 121 and 123. See also, Campbell McLachlan et al, *International Investment Arbitration: Substantive Principles* (OUP 2008) 227.

18 *Alex Genin et al v. Estonia*, ICSID Case No. ARB/99/2, Award, 25 June 2001, quoted in *Yannaca-Small* (n 8).

19 It is important to note that the arbitral tribunals in *Lauder* cases also arrived at diametrically opposite solutions when determining the question of whether the host state breached the FET standard, see *Lauder v Czech Republic*, Final Award, (2001) (UNCITRAL) (London award), can be found at <[http://www.cetnet.com/iFiles/1439-laudae-cr\\_eng.pdf](http://www.cetnet.com/iFiles/1439-laudae-cr_eng.pdf)> and *CME Czech Republic*, 13 September 2001, (Stockholm award) which is available at <<http://www.mfcr.cz/static/Arbitraz/enPartialAward.pdf>>. See also Susan D Frank, ‘The Legitimacy Crisis in Investment Treaty Arbitration: Privatizing Public International Law Through Inconsistent Decisions’ (2009) 73(4) Fordham L Rev 1521, 1557-58.

20 *Saluka Investments BV v. The Czech Republic*, Partial Award, 17 March 2006, para 483. For a similar view, see *American Manufacturing & Trading v. Republic of Zaire*, ICSID Case No. ARB/93/1, 21 February 1997; *Wena Hotels Ltd. v. Arab Republic of Egypt*, ICSID Case No. ARB/98/4, 8 December 2008.



protection and security clauses protect investors only in cases where their investments were 'affected by civil strife and physical violence'. In so holding, the tribunal therein did not find that the host state was in breach of their obligation to provide full protection and security, inasmuch as the suspension of the shares, and seizure of documents were based on justifiable grounds. In contrast, the tribunal in *Wena Hotels Ltd. v. Arab Republic of Egypt* found the host state Egypt liable for breaching the obligation to provide full protection and security.<sup>21</sup> In support of this finding, the court adopted a broad interpretation of the full protection and security provision.<sup>22</sup>

### 3) Determining the scope of the provisions on Expropriation

Tribunals have adopted different views on whether investors were exposed to indirect expropriation. In *Pope & Talbot* the court examined whether the 'control regime' of Canada amounted to an indirect expropriation.<sup>23</sup> The case involved a U.S. investor who was engaged in the softwood lumber mills business in Canada. The investor alleged that the way the host state implemented the Softwood Lumber Agreement ran counter to the NAFTA provisions on expropriation. The tribunal refused to hold that there was an indirect expropriation on the grounds that the implementation did not amount to a substantial barrier in the way of maintaining the softwood lumber mills business.<sup>24</sup> Hence the tribunal allowed the host state to introduce new regulations.

However, in *Metalclad v. Mexico*, the tribunal found that the host state, Mexico, first approved and endorsed the project and thereby made a representation on which Metalclad placed a heavy reliance.<sup>25</sup> The tribunal held that the omission of the host state to grant permission 'deprived the owner, in whole or in significant part, of the use or reasonably-to-be expected economic benefit of the property'.<sup>26</sup> Consequently, the tribunal found the host state, the Mexican Government, liable for the indirect expropriation, when it refused to grant a construction permit to Metalclad.

Despite the fact that tribunals in both *Metalclad* and *Pope & Talbot* sought to promote certainty, the tribunal in *Metalclad* adopted a different approach in determining what constitutes expropriation. This is because, unlike the *Pope & Talbot* approach which allowed the host state to introduce new regulations, the *Metalclad* decision seriously curbed the sovereign power of the host state to 'change the business environment'.

For this reason, *Pope & Talbot* had the effect of widening the protection of the investors more than what was envisaged in the *Metalclad*. *Pope & Talbot* was also not followed in many of the other landmark decisions, such as *Feldman v. Mexico*<sup>27</sup> and *S.D. Myers v. Canada*,<sup>28</sup> both which refused to treat the change of regulation as tantamount to indirect expropriation.

The case law is also not helpful in determining how long the deprivation needs to take place for the purposes of finding indirect expropriation. The two landmark arbitration awards, namely *S.D. Myers v. Canada* and *Wena Hotels v. Egypt* are divided on this point.<sup>29</sup> While the former tribunal did not find the eighteen months of

<sup>21</sup> See *Wena* (n 20).

<sup>22</sup> *ibid.* See also Guiditta Cordero Moss, 'Full Protection and Security' in Reinisch (n 8) 144-145, quoting *Siemens A.G. v. Argentine Republic*, ICSID Case No. ARB/02/8 Award, 6 February 2000, para 303; *CSOB v. Slovak Republic*, ICSID Case No. ARB/97/4, Award, 29 December 2004, para 170; *Compania de Aguas del Aconquija S.A.* (n 9).

<sup>23</sup> *Pope & Talbot Inc. v. The Government of Canada*, (UNCITRAL, NAFTA), Interim Award, 26 June 2000.

<sup>24</sup> *ibid.* See also Anne K Hoffmann, 'Indirect Expropriation' in Reinisch (n 8) 157.

<sup>25</sup> *Metalclad v. Mexico*, ICSID Case No. ARB(AF)/97/1 Award, 30 August 2000, para 106.

<sup>26</sup> *ibid.*, at paras 103-04. For a similar view, see *Tecnicas Medioambientales Tecmed, S.A.* (n 9) para 115, quoted in Hoffmann (n 24) 158.

<sup>27</sup> (2003) 42 ILM 625, 669, quoted in Surya P Subedi, *International Investment Law: Reconciling Policy and Principle* (Hart Publishing, 2008) 137.

<sup>28</sup> *S.D. Myers v. Government of Canada*, UNCITRAL (NAFTA) Partial Award (Nov. 13, 2000), quoted *ibid.*

<sup>29</sup> *ibid.* at para 283; *Wena Hotels Ltd. v. Arab Republic of Egypt*, ICSID Case No. ARB/98/4, 8 December 2008, para 9, quoted in Hoffmann (n 24) 159.



deprivation as sufficient to hold in favour of indirect expropriation, the latter tribunal held that the prevention of the owner from using the hotel for about one year amounted to indirect expropriation.<sup>30</sup>

#### 4) Interpretation of the 'Most Favoured Nation' clauses

ICSID Arbitration awards also contain inconsistent decisions regarding the interpretation of the 'Most Favoured Nation' ('MFN') clauses. MFN clauses enable investors to take advantage of the pro-investor provisions provided in other BITs, to which their state is not a party. The rulings in *Maffezini v. Spain*,<sup>31</sup> *Siemens v. Argentina*,<sup>32</sup> *Camuzzi v. Argentina*<sup>33</sup> and *Gas Natural v. Argentina*<sup>34</sup> all support the proposition that application of the MFN clause extends to the procedural and jurisdictional provisions under the BITs. Hence, by relying on the MFN clauses in the BIT entered into between the host state and the investor's state, the tribunals in these cases allowed investors to use the dispute settlement clause stipulated under the BIT signed by the Host State and other nations.

*Maffezini v. Spain*, which is the leading case on the broad application of the MFN clause, involved an Argentinean investor who successfully invoked the MFN clause under the Spain/Argentina BIT, in order to make use of the dispute settlement clause in the Chile/Argentina BIT. The latter BIT allowed the investors to directly institute arbitration proceedings, while there was a 18-month waiting period stipulated under the Spain/Argentina BIT by which the investor was originally bound.

Despite *Maffezini*, a number of subsequent cases refused to treat the MFN clauses as having such a wide scope. This narrow interpretation of the MFN clause was observed in *Salini v. Jordan*,<sup>35</sup> *Plama v. Bulgaria*<sup>36</sup> and *Telenor v. Hungary*.<sup>37</sup> The tribunals in these cases took the view that, unless there is an explicit statement to that effect, MFN clauses are not designed to provide procedural advantages to investors.

#### 5) Application of 'umbrella clauses'

It is common ground that a breach of contract on the part of states does not normally lead to any monetary liability.<sup>38</sup> Nonetheless, with the use of 'umbrella clauses' in almost all BITs, states now accept the liability for damages in case of a breach of BITs.<sup>39</sup> Despite the pressing need for clarification on where these umbrella clauses should be applied, case law again contains irreconcilable decisions. *SGS v. Pakistan* involved a contract whereby the investor, SGS, undertook to inspect the goods prior to their shipment. As a result of the termination of the contract by the Pakistan Government, SGS instituted ICSID arbitration proceedings, alleging breach of contract. The key question was whether this breach of contract constituted violation of the BIT entered into between the Switzerland and Pakistan.<sup>40</sup> At the preliminary stage, the tribunal refused to assume jurisdiction on the grounds that breach of the contract by the state cannot in any way be treated as violation of the BIT.<sup>41</sup> They held that the breach here was only contractual, and it did not come under the protection afforded by

<sup>30</sup> *ibid.*

<sup>31</sup> ICSID Case No. ARB/97/7, Decision on Jurisdiction, 25 January 2000, para 53. See generally, John W Boscariol, and Orlando E Silva, 'The Widening of the MFN Obligation and Its Impact on Investor Protection' (2005) *Intl Trade Law & Regulation* 61.

<sup>32</sup> ICSID Case No. ARB/02/8, Decision on Jurisdiction, 3 August 2004, para 120.

<sup>33</sup> ICSID Case No. ARB/03/02, Decision on Jurisdiction, 11 May 2005, para 121.

<sup>34</sup> ICSID Case No. ARB/03/10, Decision on Jurisdiction, 17 June 2005, para 28.

<sup>35</sup> ICSID Case No. ARB/02/13, Decision on Jurisdiction, 29 November 2004.

<sup>36</sup> ICSID Case No. ARB/03/24, Decision on Jurisdiction, 8 February 2005.

<sup>37</sup> See n 33. See also Andreas R Ziegler, 'Most-favoured-Nation Treatment' in Reinisch (n 8) 85.

<sup>38</sup> Subedi (n 27) 104.

<sup>39</sup> *ibid.*

<sup>40</sup> *Societe Generale de Surveillance SA v. Islamic Republic of Pakistan*, ICSID Case No. ARB/01/13, 8 September 2003, para 361, quoted in Subedi (n 27) at 105. For a similar view, see also *Impregilo v. Pakistan*, ICSID Case No. ARB/03/03/2005 para 198.

<sup>41</sup> *ibid.*



the relevant BIT. This line of reasoning was also adopted in a number of cases including *El Paso Energy v. Argentina*<sup>42</sup> and *Joy Mining Machinery v. Egypt*.<sup>43</sup> In sharp contrast to these decisions, the ICSID tribunal in *SGS v. Philippines* took the view that the umbrella clauses must have the effect of transforming the contractual breach of the states into violation of their liabilities under the relevant BITs.<sup>44</sup>

## 6) Conclusion

The tribunals have the liberty to interpret the standards of protection narrowly or broadly, and are also entitled to rely on the customary international law principles when identifying the relevant standards of protection. This situation opens a wide range of possibilities, and it unfortunately prevents parties from foreseeing their rights and obligations under the BITs.<sup>45</sup> This arises from the absence of binding precedents, as well as tribunals who tend to 'cherry pick' from past decisions to support their findings.<sup>46</sup> An appellate mechanism is badly needed to clarify the standards of protection in investment law.

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<sup>42</sup> ICSID Case No. ARB/03/15, 27 April 2006.

<sup>43</sup> ICSID Case No ARB/03/11, Award, 6 August 2004.

<sup>44</sup> ICSID Case No. ARB/02/6, 29 January 2004, para 127. For a similar view, see *Fedax v. Venezuela*, ICSID Case No. ARB/96/3, Decision on Jurisdiction, 11 July 1997; *Noble Ventures Inc. v. Romania*, ICSID Case No. ARB/01/11, ICSID Case No. ARB/96/3, Decision on Jurisdiction, 11 July 1997; *Noble Ventures Inc. v. Romania*, ICSID Case No. ARB/01/11, Award, 12 October 2005); *Bayındır v. Pakistan*, ICSID Case No. ARB/03/29, 14 November 2005). See also Yuval Shany, 'Contract Claims v. Treaty Claims: Mapping Conflicts Between ICSID Decisions on Multisourced Investment Claims' (2005) 99 Am J Intl L 835.

<sup>45</sup> For a similar view, see OK Fauchard, 'The Legal Reasoning of ICSID Tribunals: An Empirical Analysis' (2008) 19(2) Eur J Intl L 301, 337.

<sup>46</sup> See Efraim Chalamish 'The Future of Bilateral Investment Treaties: A De Facto Multilateral Agreement' (2009) Brook J Intl L 303, 315 and Pietro (n 4).



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- North American Free Trade Agreement
- Swiss Model BIT
- Vienna Convention on the Law of Treaties



# Development of Corporate Ownership and Control in China

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## Abstract

*This paper focuses on the historical development of China's corporate forms in different stages and their respective features as well as the main causes and effects. The author discusses the governmental impact upon the corporate evolution from the perspective of ownership and control and concludes on its negative influence in general. It is the aim of this article to demonstrate that governments should not interfere too much in the development of these corporate sectors and unnecessary governmental interference should subsequently be removed. Shareholder protection, particularly minority shareholder protection, should, as a result, be emphasized for adapting the modern corporate governance.*

**Key words:** *Corporate evolution, corporate law, government interference, ownership and control, shareholder protection*

## Introduction

While it seems that China's corporate system lags far behind the Western developed countries such as the United Kingdom, United States or Germany, as early as in 1904, China's first corporate law<sup>1</sup> had been promulgated by the imperial government—the Qing government—which included the rule of limited liability and equal treatment of shares among others.<sup>2</sup> Why, then has a mature corporate law system or a sound capital market failed to be established nearly a century later?

This paper focuses on the historical development of corporate forms in different stages and their respective features as well as the main causes and effects. The modern and the contemporary history will be divided into three distinctive periods: Late Qing Dynasty from 1860 to 1911, Republican Period from 1912 to 1948 and People's Republic of China since its establishment in 1949; and each distinctive period has differing phases during its own time. Those evolutions will be tracked down in the first three sections. After that, Section IV discusses lessons that can be learned from the evolutionary history in order to avoid similar mistakes in later development. Finally, a brief conclusion will be provided in Section V.

## I. Late Qing Dynasty

### *A. Prior to 1860*

The Qing Dynasty (1616-1911), as most of the previous ruling dynasties, strongly suppressed the production and distribution of commercial goods in order to maintain the agrarian dominated economy and its centralization of authority. The role of businessmen was underestimated and despised in the long history: no matter how rich they were they usually had a very low social status or rank subject to traditional Confucianism, the dominant political ideology in ancient China. Despite the existence of some examples of successful family-run firms, private businesses were strictly constrained in certain fields<sup>3</sup> and not allowed to be independently involved in large-scale production. This meant that even though private businesses operated by big families could be quite prosperous, they were firstly, rigidly limited in certain domains, and secondly, they had to obtain commercial license for trading as the premise in advance. More importantly, virtually all of these large-scale private businesses were under certain forms of state sponsorship or government patronage.<sup>4</sup> Such a situation did not only lead to a slow development of private-sector economy, but also resulted in the fact that those family-run

1 It was called “*gong si lü*”, which is different from current company law named “*gong si fa*”.

2 See *Hundred-Year History of China's Corporate Law* at <<http://www.civillaw.com.cn/Article/default.asp?id=36171>> [accessed November 12, 2012]. It was argued that shareholding was not an unfamiliar concept to the Chinese businessmen, the more meaningful innovation for the 1904 *Company Law* was to establish the rule of limited liability which could facilitate the raising of capital and attract public investors.

3 For example salt and steel production were virtually completely controlled by the imperial governments during the Ming Dynasty (1368-1644) and the Qing Dynasty.

4 Such as the deferment of tax payments. William Goetzmann and Elisabeth Köll, ‘*The History of Corporate Ownership in China*, in Randall Morck (ed), *A History of Corporate Governance around the World: Family Business Groups to Professional Managers* (University of Chicago Press, Chicago 2005) 152. And this situation lasted until 1900, when the Qing imperial government openly encouraged private businesses and industrial enterprises. Ibid 160.



firms could hardly be independent from the state.<sup>5</sup>

### ***B. 1861-1894: China's Self-Strengthening Movement***

Directly influenced by the serious defeats in the *First Opium War* (1840-1842) and *Second Opium War* (1856-1860), the Qing government (to be more precise, a group of progressive officials) launched the *Self-Strengthening Movement*. After the *Opium Wars*, the Qing government was forced to open several port cities to foreign companies and individuals and permit them to carry on business, which was strictly constrained or even forbidden in the past. In virtue of the fast growth of foreign companies in these treaty ports, the imperial government of the Qing Dynasty had to encourage the development of domestic enterprises to compete with those overseas ones. On the other side, which was of more significance, to study and adopt the advanced military technology and armaments from the West for the sake of enhancing national defence power through the movement became essential for the regime.

Three main types of enterprises evolved during this period. The first type was *guan ban* (government management), namely the enterprises that were completely funded and managed by the government. This was not a new type. For example, original salt production or imperial porcelain production did belong to this category.<sup>6</sup> However, the *guan ban* did not include projects like railroads, telegraph and mining, which required a great amount of capital and a larger base of investors, something an imperial government like the Qing government could not afford while confronting a variety of domestic and international problems. The second type of enterprise—*guan du shang ban* (government supervision and merchant management) appeared as a consequence. Under this model, merchants – a preferred term at that moment – and public investors subscribed the entire stocks from firms and took risks, although the government officials controlled the firms in reality. Despite being called *merchant management*, the merchants as shareholders in fact had no practical control rights. They might be responsible for the daily operation, but were only allowed to do so with sanction and permission from the government. Even occasionally when the government did not directly administer the personal, operational and financial affairs, these sorts of issues remained under its close supervision.

Notwithstanding the fact that the progress made by the form of *guan du shang ban* was remarkable during that period as it first-ever officially attracted the private capital to support those giant projects with great financial demand and indirectly allowed the private actors to engage in the large industrial sectors, disadvantages were also self-evident. The merchants among public investors as shareholders were not able to enjoy ownership rights: first, they had to surrender part of profits to the government;<sup>7</sup> secondly, they had no control of the firms they invested to a great extent. Moreover, the increasingly severe conflicts, including differing agendas between merchants and government officials, the bureaucracy, and thereby the low efficiency caused by it led to the public investors being less willing to invest in the firms controlled and supervised by the government.

To further attract private investment, the Qing government set up a third form of enterprise—*guan shang he ban* (joint government-merchant management). There were several new features under this model: firstly, government and merchants would subscribe firm stocks and undertake the risks of the business together; secondly, merchants and public investors had more rights since they could send their own representatives to engage in the management; thirdly, the government and merchants were required to make explicit contracts or arrangements specifying the right and obligation of each group, the respective proportion of profits and measures of distributing. The form of *guan shang he ban* was supposed to provide more flexibility for drawing capital from the general public, particularly merchants who were comparatively more wealthy, for developing

<sup>5</sup> They are not infrequently compelled to donate a large sum of money to the government in order to keep a good relationship with it and they would be easily affected by the political factors since there was not any legal protection. Man Bun Kwan, *The Salt Merchants of Tianjin: State-Making and Civil Society in Late Imperial China* (University of Hawai'i Press, Honolulu 2001) 37-45.

<sup>6</sup> Indeed, the private businesses are strictly restrained to participate in these areas.

<sup>7</sup> The government had the power to decide the profit allocation despite the fact that merchants contributed the entire equity capital. J Fairbank and K Liu (eds), *The Cambridge History of China: Volume 11, Late Ch'ing, 1800-1911* (Cambridge University Press, Cambridge 1980) 434-435.





domestic enterprises, because exclusively private industrial firms were still not allowed to be independently established without the involvement of the government until the end of nineteenth century.

Unfortunately, the managerial power still largely rested on government officials, while merchants' representatives were practically powerless. This ultimately failed to attract enough private funds as expected. The contradiction and dilemma here was apparent. For one thing, the Qing government wished to study the military weapon and advanced technology from the Western countries and then to compete with them. But for another, the imperial government did not expect a complete reform even in the economic field with the fear of losing its controlling position as well as the potential incompatible clash with traditional morality. In short, there was no intention to reform the old institutions for the Qing government.<sup>8</sup> Government-dominated corporate forms in the late Qing Dynasty with corruption and an ineffective political system were doomed due to failure to attract desperately demanded capital. Without enough funds to establish and develop companies and with severe restraints upon private firms, the overall development of both public and private firms during this period was disappointing and the *Self-Strengthening Movement* was finally aborted.

### C. 1895-1911: The Late-Qing Reforming Period

The defeat in the *First Sino-Japanese War* (*jia wu zhan zheng*) gave the Qing government a deeper strike. Apart from the enormous compensation, the Qing government was compelled to pay, as in the situations of the two *Opium Wars* but with a much larger amount,<sup>9</sup> in terms of article 6 of *Treaty of Shimonoseki*, the post-war treaty between the Qing and Japanese government in 1895, the Qing government was also forced to permit foreigners, *viz.* Japanese citizens, to build factories. It should be noticed that though foreigners could do business in those port cities after the first *Opium War*, they were not allowed to build factories in order to engage in the manufacturing process. Until then, the policy of forbidding Chinese citizens from engaging in industrial firms while allowing foreigners to do so became senseless. From 1895 onwards, private firms in light industry as well as the consumer goods industry developed very fast as observed by Professors William Goetzmann and Elisabeth Köll, especially in those original *guan du shang ban* (government supervision and merchant management) and *guan shang he ban* (joint government-merchant management) enterprises by virtue of eliminating the restrictions.<sup>10</sup>

In order to further facilitate commerce and help industries, the Qing government established a Ministry of Commerce and enacted China's first *Company Law*, *gong si lü* in 1904,<sup>11</sup> with the expectation of establishing shareholder-friendly environment to encourage private investment. It is worth mentioning that during the late nineteenth century and early twentieth century, cotton-spinning mills and some other industries remained of high risks. The rule of limited liability introduced by the 1904 *Company Law* substantially facilitated investors, who in the past might have feared the unlimited liability when the business failed, to put money into the company. Purchasing stocks from the specific company or the public market would only risk the corresponding value instead of the entire personal wealth, because the liability had been limited to the value of the shares they initially subscribed.<sup>12</sup> Consequently, fears that once largely restricted the size and scope of companies could be removed by the new law, while raising large amount of capitals turned to be feasible at

8 The strategy is "*zhong xue wei ti, xi xue wei yong*" (Chinese Learning for Fundamental Principles and Western Learning for Practical Uses). The political *status quo* of a conservative imperial monarchy is the forbidden area to touch.

9 The Qing Government was forced to pay an indemnity of 230 million *silver kuping taels* to Japan in total. Since one *kuping (treasury) tael* was about 37.3 grams in weight, it meant China had to pay approximately 8.56 million kilograms of silver.

10 W Goetzmann and E Köll, 'The History of Corporate Ownership in China, in Randall Morck (ed), *A History of Corporate Governance around the World: Family Business Groups to Professional Managers* (University of Chicago Press, Chicago 2005) 160.

11 It was commented by Professor William Kirby: "The Company Law was the first modern law drafted by the Imperial Law Codification Commission, whose work was part of the Qing government's reformist "new policies" in the wake of China's recent humiliations at the hands of Japan and the Western powers." William Kirby, 'China Unincorporated: Company Law and Business Enterprise in Twentieth-Century China' (1995) 54 *Journal of Asian Studies* 43, 43.

12 For the detailed positive effect of 'Limited Liability', please see H Hansmann and R Kraakman, The Essential Role of Organizational Law, (2000) 110 *Yale Law Journal* 387; H Hansmann, R Kraakman and R Squire, 'Law and the Rise of the Firm' (2006) 119 *Harvard Law Review* 1333.



least from the technical aspect. What is more important for China's political and economic environment that time was, as aptly noticed by some scholars, the "hands-off" effect of the 1904 *Company Law*—i.e., replacing state patronage and government interference with a set of explicit legal rules to enhance shareholder rights.<sup>13</sup> Put it simply, shareholders were designed to become the central players for substituting the traditional role of government in the corporate activity.

Some optimistic observers might think that with a series of economic reforms and the appearance of modern company laws, China seemed to possess the conditions of developing modern corporations. However, this never happened in the following eight decades since the promulgation of the first modern company law in 1904. Even after eliminating governmental interference and enacting the rule of limited liability, without an accessible capital market, the difficulty of raising capital remained a huge problem and obstacle for the development of private companies. In the absence of an accessible capital market, it was hard to raise money from the public. One often-mentioned reason for weak shareholder rights or unfettered managerial power was the lack of an active stock market for domestic companies. Despite the fact that the first securities market emerged in Shanghai as early as in 1870s, subsequent to a string of booms it came to be an ineffective capital market for the domestic companies.<sup>14</sup> In particular, the stock market crisis in the middle of 1880s (the first bubble of China's stock market), which was principally contributed to by price manipulation and insider trading,<sup>15</sup> heavily struck the investors' confidence.

On top of that, the government withdrawing from direct involvement did not necessarily mean that control rights would return to shareholders as a whole, it could possibly be transferred to a blockholder or a small group of large shareholders. In reality, the founder/managing director took the control. There were two major causes: first, the founder or managing directors would establish "institutional structures of control in combination with social networks"<sup>16</sup>; secondly, the legal enforcement mechanism did not work well, thus it would be difficult to expect the court to effectively implement the existing legal institutions and to safeguard shareholders' legitimate rights.<sup>17</sup>

Difficulty ascended when there was inadequate legal protection for the minority shareholders. Companies were firmly controlled by the founders or managing directors after the government's withdrawal and it was almost impossible for those disgruntled minority shareholders to effectively express their opinions. Some institutions introduced by the 1904 law, such as the requirement of *auditor*, became rubber-stamps owing to the fact that the founder or managing director usually dominated the board. This, in turn, resulted in, or at least enhanced the tradition of raising capital from kinship and interpersonal networks. Just as Gary Hamilton correctly commented, "kinship and native place collegiality constitute an *institutional medium* out of which people create organized networks. In this regard, kinship and collegiality in China played a role analogous to those played by law and individuality in the West".<sup>18</sup> Family ties and interpersonal networks became the only reliable source of capital, since such relationships can provide certain protection and guarantees while strangers did not dare to risk their money under the management of someone they did not know before, just as

13 W Goetzmann and E Köll, 'The History of Corporate Ownership in China, in Randall Morck (ed), *A History of Corporate Governance around the World: Family Business Groups to Professional Managers* (University of Chicago Press, Chicago 2005) 163.

14 However, the Shanghai Stock Exchange worked quite well for the foreign-domiciled companies. Indeed it became one of the most active stock markets around the world at the time. Ibid 151.

15 As Professors William Goetzmann and Elisabeth Köll interestingly point out: "at about the time that robber barons Gould and Fisk were manipulating prices of railroad securities on the New York Stock Exchange, the Shanghai market suffered from the same problems of insider trading". Ibid 155-56.

16 Ibid 171.

17 As observed by Dwight Perkins, businessmen are not prepared to go to the local magistrate which is responsible for dealing with disputes including commercial ones, as they believe the officials in the magistrate neither competent nor impartial. This means that even if the 1904 Company Law does state certain sort of shareholder rights, when they are infringed, no effective legal enforcement mechanism exists to protect these rights. Ibid 183.

18 Gary Hamilton, 'The Organizational Foundations of Western and Chinese Commerce: A Historical and Comparative Analysis' in Gary Hamilton (ed) *Asian Business Networks* (De Gruyter, Berlin 1996) 43.



one Chinese scholar aptly observed:

“The idea that members of the public would be invited to join one’s business and share in its control and profits was indeed repugnant. On the other hand, the notion that one’s money be put into the pocket of some strangers for them to run a business was just as unthinkable”.<sup>19</sup>

Such imbedded distrust and problematic legal enforcement mechanisms along with an inaccessible public market substantially restricted the development of the corporate form.

## II. Republican Period

With the collapse of the Qing Dynasty, the previous centralised authority was substantially weakened. Just as the picture depicted by Professor Dwight Perkins illustrates, governments of the first few decades of the twentieth century “had little capacity to do much of anything other than to mobilize an army to fight the government’s political opponents”.<sup>20</sup> On the grounds of the declining state authority, the political stimulus to boycott foreign commodities and the enthusiasm of developing domestic companies, this period was seen as the golden age of Chinese capitalism.<sup>21</sup> Nonetheless, the difficulty of raising capital persisted. Although more business and commercial activities were conducted between strangers, rent and mortgage remained the paramount method of financing, rather than equity purchasing.<sup>22</sup> Preferring debt investment to equity was affected by the traditional standpoint. More crucially, the prevalence of *blockholders* and controlling shareholders, as well as the inadequate protection for minority shareholders, may all have contributed to the above situation.

After 1927, the newly-established *Kuomintang*’s Nanjing government led by Chiang Kai-shek gradually acquired the ruling position over the nation, which is argued by some historians as the indication of “the bureaucracy’s return in force and the decline of the bourgeoisie”<sup>23</sup>. It was followed by the era of nationalization of the company, and the state again dominated the development of all fundamental heavy industries and infrastructure. The start of the *Sino-Japanese War* in 1937 indisputably accelerated the scope and pace of such nationalization. As the statistics showed, by 1942, the state controlled 70% of the total capital of China’s industry.<sup>24</sup> Take the National Resource Commission (NRC), which was the largest state industrial agency as an example; some of NRC’s over 100 organizations either operated as “purely administrative units” or completely NRC-owned companies, while others took the public-private form where NRC accounts for the majority shares without any exception.<sup>25</sup>

In the meantime, the Nanjing government had already drafted the Five-Year and Ten-Year Plans for the post-war period, which focused on the state-dominated development direction by 1943-1944.<sup>26</sup> Given that *Kuomintang* (KMT) could preserve the regime for a longer period, it would be logical to predicate the further centralisation of economic power in the hands of the state and continuously the contraction of the non-governmental companies in the foreseeable future.

19 Jun Li, ‘The Kung-ssu-lu of 1904 and Modernization of Chinese Company Law’ (1974) 11 *Chengchi University Legal Review* 205 quoted in William Kirby, ‘China Unincorporated: Company Law and Business Enterprise in Twentieth-Century China’ (1995) 54 *Journal of Asian Studies* 43, 50.

20 Randall Morck (ed), *A History of Corporate Governance around the World: Family Business Groups to Professional Managers* (University of Chicago Press, Chicago 2005) 183.

21 For example, see William Kirby, ‘China Unincorporated: Company Law and Business Enterprise in Twentieth-Century China’ (1995) 54 *Journal of Asian Studies* 43, 48-49.

22 Ibid 49, 50.

23 Marie-Claire Bergère, *The Golden Age of the Chinese Bourgeoisie* (Cambridge University Press, Cambridge 1990) 272.

24 J Sun, *Economic History of China 1840-1949* (China People’s University Press, Beijing 2000) 1237-1240.

25 Some other organizations, mostly mining firms, were organized as limited joint-stock companies between provincial governments and NRC. W Kirby, ‘China Unincorporated: Company Law and Business Enterprise in Twentieth-Century China’ (1995) 54 *Journal of Asian Studies* 43, 53.

26 Ibid 54.



### III. People's Republic of China

#### A. 1949-1983: Socialist Transformation and State-Owned Enterprises

Subsequent to a lengthy civil war against KMT, the *Communist Party of China* (CPC) took over the full control of Mainland China and established the People's Republic of China (PRC) in 1949. The communism or socialism ideology then determined the ownership structure in society. Articles 5, 6 and 7 of the 1954 *Constitution of the People's Republic of China* – the first Constitution of PRC – specified two major categories of ownership: first, state ownership, i.e., ownership by the whole people; secondly, co-operative ownership, i.e., collective ownership by the masses of working people.<sup>27</sup>

Private ownership was not allowed and entirely abolished during the socialist transformation period. Apart from a small fraction of cooperative-owned enterprises, the vast majority of the corporations in the first three decades since 1949 were state-owned. Though state-owned property belonged to every Chinese person in name, as criticized by many contemporary scholars, belonging to *the whole people* equals belonging to nobody.<sup>28</sup> It is simply impossible for every citizen to engage in corporate activities in spite of the fact that he or she theoretically has a stake in it. Inevitably, the government represents *the whole people* in holding and exercising the ownership rights. The state utilized its finances to fund SOEs, and then completely controlled the management and operation of those companies.

More importantly, under the planned system, every single segment from the resource allocation to consumption, from investment and operation to production and distribution, was totally planned by the state in advance. The State-Owned Enterprises (SOEs) during this period functioned not materially different from government affiliates: their almost sole objective was to complete the task assigned by the state or say government. Having profit never necessarily became a major issue for the official-like managers of SOEs. Even though continuous losses for a particular company appeared, as long as the assignment allocated by the state was fulfilled, then the government would usually give financial support to such companies instead of blaming them.<sup>29</sup> Both ownership and control lay in the hands of the state. Talking about corporate governance, which is most likely to be derived from a free market economy, became ironic under such a centrally-planned economy, on the grounds that any governance mechanism was replaced by the bureaucratic administration. Enterprises functioned no differently from government affiliates or government-like organizations.

#### B. 1984-1992: Enterprise Reform

In October of 1984, the Third Plenum of the Twelfth CPC National Congress determined the economic structural reform (*jing ji ti zhi gai ge*), and decided to develop a socialist commodity economy (*she hui zhu*

<sup>27</sup> Beyond these two principal ownership forms, there were two other forms, namely ownership by individual working people and capitalist ownership. The former type was strictly restrained in terms of the scale, which implied it could not develop and play an important role; indeed during the following two decades, private trading was suspended under the planned economy system. For the latter type, though such capitalist ownership pattern contributed dramatically to the overall economy and national prosperity during the past half century, it was becoming insignificant after 1949. Articles 4 and 10 of the PRC *Constitution* explicitly specified that the system of exploitation, which principally meant capitalism, should be abolished. Such capitalist industry among others were indeed strictly restrained and transformed into various forms of state-capitalist in the following periods until the ownership by the whole people replacing all of them.

Moreover, compared with state-owned enterprises, which was defined as the leading force in the national economy and the material basis on which the state undertakes the socialist transformation according to Article 6 of the *Constitution*, co-operative owned enterprises were comparatively smaller in scale. In fact, cooperative ownership mainly referred to ownership type of land in rural areas of China by aggregates of peasants. As a result, during this period, the state-ownership structure will be focused on.

<sup>28</sup> For example, see L Joyce, 'From Non-tradable to Tradable Shares: Split Share Structure Reform of China's Listed Companies' (2008) 8 *Journal of Corporate Law Studies* 57, 76; ZJ Lin, LM Liu, and X Zhang, 'The Development of Corporate Governance in China' (2007) 28 *Company Lawyer* 195, 199; SM Cai and YX Deng, 'Corporate Governance in China—Obstacles and New Development' (2001) 29 *International Business Lawyer* 455, 456.

<sup>29</sup> In fact, during most parts of this period, no real market existed, so it is less meaningful to discuss "profits" while everything was planned. And even if an SOE suffered a constant loss, due to the fact that no exit mechanism had existed, the particular SOE would not be forced into bankruptcy; instead, the state would keep injecting capital into the insolvent SOE.





*yi shang pin jing ji*), relying on the *law of value* within the system of the planned economy. This indicated that the role of the market was first officially and publicly recognised in PRC. More excitingly, enabling enterprises to be more active became the focal issue of this reform, as expressed by the *Central Committee of CPC's Decision of Economic Structural Reform*. As a consequence, the obligations of the government and SOEs had to be explicitly divided; the responsibility to manage SOEs was given back to companies *as such*. The government, as stipulated by the *Decision*, was requested not to interfere with the management of SOEs.

The government believed the problems of SOEs were attributable to the lack of managerial autonomy and a proper performance-based reward system. Subsequently, SOEs were granted more autonomy in order to be enabled to make operational decisions independently and to be responsible for their own operation, and incentive mechanisms based on managerial performance were gradually established. The management contract responsibility system (*jing ying cheng bao ze ren zhi*) was another direct product of the 1984 *Reform*. A typical management contract would contain the arrangements of an agreed amount of profits among other fees paid to the government as the contracted responsibility and the allocation measure of exceeding profits between the government and the SOE management team. Its essence as following the guideline of the *Economic Structural Reform* was to separate the management from the ownership. Managers of SOEs certainly did not have ownership rights because virtually all shares belonged to the state. However, the *Reform* entitled managers to possess relatively autonomous managerial power and independent discretion on the operation as opposed to situations in the past. Moreover, SOEs were permitted to retain additional profits as long as the returns exceeded a fixed amount specified by the state, and managers could also be correspondingly rewarded for a proportional bonus. These new designs were supposed to motivate managers to make optimal decisions and work more effectively.<sup>30</sup>

In the latter half of 1980s, an increasingly growing number of SOEs started to securitize, and from 1986 onwards, their stocks began to be tradable over-the-counter.<sup>31</sup> The Shanghai Stock Exchange and Shenzhen Stock Exchange were established at the end of 1990. In the following year, China Securities Regulatory Commission (CSRC) was set up as the national regulator of securities exchanges. The emergence of the stockholding system constituted the foundations for raising capital to support the development of large companies. As reminded by the lessons from the Qing and Republican periods, active and accessible securities markets are essential bases for the growth of private-sector companies in contrast to government-sponsored ones.

Notwithstanding the material improvement achieved, there are three fatal limits of the reform in this period. First, as the state controls the power of appointment and removal with respect to the management, it was not impossible for the government to remove a non-obedient manager. Also, interestingly, the managers in SOEs would usually have certain administrative ranks and could be exchanged directly with officials in central or local governments.<sup>32</sup> Managers are consequently more loyal to the government than the company they run. Secondly, while the profitable SOEs are able to enjoy the additional profits, the unprofitable or losing SOEs could not afford the fixed amount committed to the state. Due to the fact that no exit mechanism existed, managers of the unsuccessful SOEs could not feel valid competitive pressure. Thirdly, myopic decision-making was hardly able to be avoided due to the short-term nature of management contracts. The short-termism resulted in many serious problems including pursuing immediate income maximisation at the expense of the long-term benefits.<sup>33</sup> In the end, the high debt-to-asset ratio became the strong impetus for the further ownership reform since merely corporatizing SOEs without thoroughly reforming ownership structure

30 According to management responsibility contract, if there occurs a loss, the SOE has to offset the deficit.

31 M Ellman, 'China's OTC Markets' (1988) 30 *Comparative Economic Studies* 9-64 quoted in Y Kang, L Shi, and E Brown, *Chinese Corporate Governance: History and Institutional Framework* (Rand Corporation, Santa Monica 2008) 6.

32 M Yan, 'Obstacles in China's Corporate Governance' (2011) 34 *Company Lawyer* 311, 318.

33 For example, the R&D department is most likely to be overlooked as it cannot contribute a fast return. Meanwhile, because those SOEs are still owned by the state, such short-term behavior would ultimately hurt the state interest.





seems impossible to succeed.<sup>34</sup>

### ***C. 1993-2005: Socialist Market Economy***

In October of 1992, the Fourteenth CPC National Congress first expressly raised the policy of establishing a socialist market economy (*she hui zhu yi shi chang jing ji*).<sup>35</sup> It should be noted that China started to enter into a new economic era with a market economy, from its initial centrally planned economy. Then in 1993, the first company law of PRC was promulgated, one which granted SOEs an independent status. Pursuant to article 3 of the 1993 *Company Law*, all incorporated companies are legal persons with independent personality in law, and responsible for its own behaviour. Furthermore, the Fifteenth CPC National Congress in 1997 and its Fourth Plenum in 1999 made a series of theoretical innovations to overcome the ideological obstacles for SOE reforms. The private ownership,<sup>36</sup> from being eliminated and prohibited in the beginning, was gradually permitted in the late 1980s and recognized as a beneficial supplement to the public ownership since the Thirteenth CPC National Congress. After the Fourteenth CPC National Congress, especially the Fifteenth one, private ownership started to be seen as an important part of the whole economy which implies such an ownership pattern would be continuously encouraged. The subsequent amendment to the *Constitution* in 1999 clarified that non-public sectors of the economy, including the individual and private sectors, constituted an important component of the socialist market economy. Multiple forms of ownership structure, particularly the private ownership, hence, turned out to be the new developing direction with the great expectation by policy makers of improving the productivity and efficiency of national industries. All enterprises including SOEs were then required to establish modern corporate governance structure as being the kernel of modern enterprise transformation.<sup>37</sup>

The ownership reform, in contrast to the management-oriented reform in the previous period, does not only statutorily allow, but also encourages investment from private sectors. The percentage of private ownership was rapidly increased in the original SOEs. Actually, from the time of establishing the security market, the role of private capitals has come out to be gradually outstanding, because one fundamental sense of having stock markets is for raising capital from numerous individuals and entities. Diversifying types of corporate ownership to change the situation where the state was the sole or controlling shareholder became the trend. By and large, more structural and organizational autonomy was granted to individual SOEs in virtue of the *corporatization* process.<sup>38</sup> The implicit privatization revitalized the corporate sectors. Meanwhile, the promulgation of *Securities Law* by the end of 1998 and the more active role taken by CSRC along with a series of corporate governance codes greatly improved the shareholder-friendly investment environment.

Nonetheless, subsequent to granting managers more autonomy and discretion, the issue as to how to keep in check the conflict between shareholders and managers should not be disregarded as well. The protection of shareholder interests was of growing importance. More crucially, the problematic independent director system and the fact that the state remains the controlling shareholder among others, gave rise to the issue of minority shareholder protection. Up to this time, the state could still dominate and then pursue its own objectives under such multiple forms of ownership structure, and management continued to be not infrequently subordinated to the controlling shareholders, as well as serve their interest at the expense of the minority shareholders. As one officer of the Shanghai Stock Exchange summarizes, most directors understand the principles of

34 Y Kang, L Shi, and E Brown, *Chinese Corporate Governance: History and Institutional Framework* (Rand Corporation, Santa Monica 2008)

7. In fact, according to the statistics, more than two thirds of SOEs were in loss at the start of 1990s. Y Qian, *Reforming Corporate Governance and Finance in China* (Economic Development Institute of the World Bank, 1994).

35 It is indeed a mixture of state-owned enterprises with an open-market economy and mainly based on the paramount CPC leader Deng Xiaoping's political innovation of *you zhong guo te se de she hui zhu yi* (socialism with Chinese characteristics).

36 Here, the individual economy is excluded, (i.e., ownership by individual working people such as craftsman) which is insignificant compared with other forms.

37 In fact, at the same time, the importance of corporate governance also arises under the new business structure.

38 For example, see Voß. S and YW Xia, 'Corporate Governance of Listed Companies in China' 8, at <[http://www.ctw-congress.de/ifsam/download/track\\_8/pap00750.pdf](http://www.ctw-congress.de/ifsam/download/track_8/pap00750.pdf)> [Accessed February 5, 2011].



good corporate governance as well as its significance but not just a few of them continue to think that their relationship with the government is more important than with (the minority) shareholder in the transition from a centrally-planned to market-oriented market.<sup>39</sup> The focal point in the corporate structure changes into the question of how to effectively protect those public individual investors as minority shareholders while the state stays as the majority one. Taking one step back, even here, it can be noted that the influential political factor of the state is removed. Minority shareholders remained vulnerable under the context of concentrated ownership structure since managers, block-holders or both could effortlessly exploit them. In addition, state ownership is regarded as having a negative impact on the performance and value of the company from the economic perspective, as argued by many scholars.<sup>40</sup> On the contrary, both private and institutional investors regardless of whether they are domestic or foreign could generally offer positive contribution.<sup>41</sup> All of these imply that further reform remained necessary.

#### ***D. From 2005 onward: Further Reform***

Further reforms have continued to be pushed ahead since 2005. First of all, the revised *Company Law* in 2005 brings with it many new changes. For instance, it makes the independent director system a legal requirement and accords shareholders more channels to appeal when they find misconduct exists or feel harmed.<sup>42</sup> Many good corporate governance structures stemming from Western countries have also been introduced and transplanted into China.

Besides, another sweeping and far-reaching reform is in the field of the traditional split-share system. As known, shares in China's stock market are classified into two main categories, namely tradable and non-tradable shares. The latter category is comprised of state shares<sup>43</sup> and legal person shares<sup>44</sup>. Each accounted for approximately one-third of all shares until 2005. Therefore, the controlling shareholder (i.e., state) who had owned shares either directly or indirectly through legal persons<sup>45</sup> was entrenched and almost immutable on grounds that approximately two-thirds of all shares could not be transferred in the stock market.<sup>46</sup> In 2005, CSRC carried on with the strategy to lower the state's shareholding by converting non-tradable shares to tradable shares again as it was once stopped in the early period of the twenty-first century. Following an initial

39 N Andrews and R Tomasic, 'Directing China's Top 100 Listed Companies: Corporate Governance in an Emerging Market Economy,' (2006) 2 *Corporate Governance Law Review* 245, 308-309.

40 For example, see M Hovey, 'Corporate Governance in China: An Analysis of Ownership Changes after the 1997 Announcement' (2005) Available at <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=811105](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=811105)> [Accessed February 5, 2013]; C Wang, 'Ownership and Operating Performance of Chinese IPOs' (2005) 29 *Journal of Banking & Finance* 1835-185; Z Wei, F Xie, and S Zhang, 'Ownership Structure and Firm Value in China's Privatized Firms: 1991-2001' (2005) 40 *Journal of Financial and Quantitative Analysis* 87-108; M Hovey, L Li, and T Naughton, 'The Relationship Between Valuation and Ownership of Listed Firms in China' (2003) 11 *Corporate Governance: An International Review* 112-122; F Gul, 'Government Share Ownership, Investment Opportunity Set and Corporate Policy Choices in China' (1999) 7 *Pacific-Basin Finance Journal* 157-172; J Chen, 'Ownership Structure as Corporate Governance Mechanism: Evidence from Chinese Listed Companies' (2001) 34 *Economics of Planning* 53-72.

41 M Hovey and T Naughton, 'A Survey of Enterprise Reforms in China: The Way Forward' (2007) 31 *Economic Systems* 138-156.

42 Such as Articles 54, 103, 152 of the 2005 *Company Law*.

43 State shares are defined as *shares legally invested with state funds in a company by officially approved departments or organizations that can represent the state to invest*.

44 Legal person shares are defined as *shares invested in other companies by enterprises that are owned by 'the whole people' and granted operational autonomy*. It should be noticed that the distinction between state shares and legal person shares is questionable; it is said that legal persons can be owned or controlled by the state which means that their shares also belong to the state to some extent. D Clarke, 'Independent Directors in Chinese Corporate Governance' (2006) 31 *Delaware Journal of Corporate Law* 125, 133. However, it is not the purpose of this article to discuss the differences between them.

45 "Legal persons" include stock companies, non-bank financial institutions and SOEs with at least one non-state shareholder. Most legal persons are ultimately controlled by the state.

46 This means that the minority shareholder or outsiders can never, through transactions in the stock market, gain control of the company on the grounds that only about one-third of shares are issued to the public, while the other two-thirds are firmly in the hands of the state. Gradually, management understands that they will not lose jobs even if they run a company unprofitably since the company would rarely be in danger of takeover. Instead, the paramount job for these directors and senior managers is to satisfy their controlling shareholder in order to preserve their position and get generous compensation. It has also been argued that because of the nature of non-transferability, the controlling shareholders with non-tradable shares do not care about the fluctuation of prices of shares in the stock market, a situation exacerbated by the fact that the state as the controlling shareholder usually uses its dominant control for certain political considerations other than maximising profits. M Yan, 'Obstacles in China's Corporate Governance' (2011) 34 *Company Lawyer* 311, 314.



success of *Beijing Tsinghua Tongfang*, as well as three other listed companies' experiment, a second group of 42 listed companies was later requested to join in the split-share reform, and finally the reform was extended to the rest of the domestic-listed companies<sup>47</sup> by the end of 2005.

The reform on the split-share structure is incontrovertibly beneficial to the further development of the capital market and enables controlling shareholders to be exposed directly to market pressure and supervision. Public investors, including both individual and institutional ones, can thereby obtain a fairer environment with more accessible protection. And the market for corporate control, with hostile takeover in particular, which is seen as the ultimate disciplinary mechanism by neoclassical economists, now becomes viable in the light of such split-share reform. At the least, the fundamental obstacle from the free market aspect is removed.

In a nutshell, the continuous economic reforms in the last three decades have materially metamorphosed and reconstructed the economic situations, including corporate structures. In particular, the free market is not only allowed but encouraged to efficiently perform the resource allocation role and an effective legal framework has also generally been set up to ensure the infringed shareholder can obtain a remedy without unreasonable difficulties. These will definitely foster further development.

#### IV. Lessons from History

Progress is usually based on historical experiences and lessons. If we can learn something from the corporate evolution history in China, then the most significant lesson, at least from the ownership structure and modern corporate governance perspective, should be the abstention from excessive state interference. There is no necessity for excessive state involvement. In fact, the company can run as well or even better by self-governing at the micro-level as long as a good governance system exists.

Over one hundred and fifty years of corporate evolution, governments during different periods always played an active and dominant role. In this regard, history moves in cycles. First, it went complete control at the start of the late Qing Dynasty to gradually granting more self-governing and discretionary powers on management back to the private investors. The next phase entailed a period where the government once again concentrated economic power by nationalizing a majority of industrial companies as well as financial ones.<sup>48</sup> The establishment of the PRC then followed this, when the new government first completely obtained the control of the economic sector and then corporatized all the SOEs. The engagement of private-sector actors seems essential for economic success. Nonetheless, it is observed that no matter how effectively the market-oriented economy runs, "the idea that planning is essential for China's economic development remains in the mind of government officials until today".<sup>49</sup> In particular, the recent worldwide economic recession led China to take more active macroeconomic stimulus policy to revitalize the domestic economy, and suggests the central planning is still significant to China's economy.

Nevertheless, directing or influencing the economy can be realized by approaches other than immediately controlling a multitude of large companies. Withdrawing from the companies (mainly, SOEs) does not necessarily indicate that the government would lose control over the national economy—or as the often-appeared argument runs, that the public interest would be negatively affected if those strategically significant sectors are not in the hands of the government. Admittedly, it is easier for the government to fulfil their economic, political or social objectives given that the government holds a great number of companies which

47 According to the CSRC statistics, there were a total of 1,377 domestic companies which were listed on China's A-share and B-share stock markets in 2005, and most of them were state-owned.

48 It can be estimated that if the *Kuomintang*, the ruling party at the time, was not defeated by the *Communist Party*, it may have also adopted policies to divest in corporate sectors, allowing and encouraging private capitals to be involved as that characterized by Taiwan, which is still ruled by *Kuomintang*.

49 G Chow, 'Economic Planning in China' *Princeton University CEPS Working Paper No.219* (2011).



in turn control substantial quantities of economic resources.<sup>50</sup> Yet, policy, legal and economic measures among others can be utilized to achieve the same end instead of controlling the companies and resources directly. For instance, utilizing economic incentives such as favourable tax policies or direct financial subsidies and loans to motivate privately-owned companies to enter into certain fields or engage in certain activities, with essential macro-control measures occasionally implemented. As soon as the government stops to interfere, the market can perform its role and effectively allocate resources to meet various demands. Concerning the protection of public interests, as the market has its own limits from time to time, it is absolutely feasible for the government to set up specific rules or laws to regulate and sometimes restrict certain behaviours. The only problem as incisively pointed out by one of the most prominent Chinese economist is:

Some people, particularly the social and political elites, have tremendous interest in maintaining the old system. If those people with vested interests in the old system cannot regard the interest of the entire society as of primary importance, they will use all kinds of excuses, including political ones, to hinder the progress of reform and restructuring.<sup>51</sup>

This is indeed confirmed by the argument put forward by Professors Lucian Bebchuk and Mark Roe, who write:

[Existing] corporate structures might well have persistence power due to internal rent-seeking, even if they cease to be efficient. Those parties who participate in corporate control under an existing structure might have the incentive and power to impede changes that would reduce their private benefits of control even if the change would be efficient.<sup>52</sup>

Thus, it is plain to conclude that giving up the control over SOEs will not hurt the national economy and public interests as long as the related supporting measures are adopted. Those who will be adversely affected are the people with vested interests in the old SOE system, since the control is able to produce rent-seeking, among other thing. Without state control, the so-called state economic lifeline, excepting industries involving national securities, could be served well given that market system and corresponding regulations are established.<sup>53</sup>

## V. Conclusion

History as well as contemporary empirical research clearly tells us that a government-centred model, except under certain specific conditions like wartime, would generally give rise to a negative impact on corporate development. Through the above discussion, it becomes evident that both economically and politically, the interference from the government should be strictly-restrained in order to allow the market, and self-governance at the micro-level, to perform a more active and decisive role in corporate governance practices and economic activities. The future development of China's economy will depend on the rapid growth of the corporate sector, which in turn relies more on its autonomy and the market; and such a developing trend will sustain over a long time with the deepening of reform and globalisation. The government should not interfere too much in the development of these corporate sectors and shareholder protection, particularly minority shareholder protection, should as a result be emphasized for adapting the modern corporate governance.

50 For example, it might be argued, as some scholars do, that China's government wants to retain the ownership of its traditional SOEs in order to ask them to fulfill more tasks than simply wealth maximisation. D Clarke, 'Corporate Governance in China: An Overview' (2003) 14 *China Economic Review* 494, 494-495 and 497-499.

51 Jinglian Wu, 'China's Economic Reform: Past, Present and Future' available at <[http://www.oycf.org/Perspectives2/5\\_043000/china.htm](http://www.oycf.org/Perspectives2/5_043000/china.htm)> [accessed 6<sup>th</sup> November, 2012].

52 L Bebchuk and M Roe, 'A Theory of Path Dependence in Corporate Ownership and Governance' (1999) 52 *Stanford Law Review* 127, 130.

53 Another important reason might be for maintaining the ruling status. Given that direct control is held by the state, it will be beneficial to ensure stability since the government can more easily reallocate or distribute resources among other things without explaining to the public. In contrast, if the state surrenders such direct control, then it has to rely on laws, rules, economic measures and alike to regulate and guide the development as discussed above, all of which call for explicit supporting reasons and can no longer be manipulated through black-box operation as they would be exposed to the whole people. Some earlier actions will not work under the new circumstances, and the existing government will surely encounter more direct and indirect challenges.

In addition, as mentioned by Professor Donald Clarke, the embedded *official suspicion* of "accumulations of wealth" or "any organized activity" not controlled or led by the government, see D.C. Clarke, 'Corporate Governance in China: An Overview', *China Economic Review*, 14 (2003), 494-507 at 496. would result in the reluctance of the Chinese government in further releasing its control over SOEs.



# House of Lords Reform: Where now?

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## Introduction

To borrow an opening from Lord Bingham<sup>1</sup>, Lord Hailsham wrote of the House of Lords:

“No one in his right mind could ever have invented the House of Lords with its archbishops and bishops, Lords of Appeal in Ordinary, hereditary peerages marshalled into hierarchical grades of dukes, marquesses, earls, viscounts and barons, its life peers nominated by the executive, its truncated powers, its absence of internal discipline and its liability to abolition.”<sup>2</sup>

The structure and function of the House has been a constant issue in the political and constitutional law spheres for over a century. Indeed, the pre-amble to Parliament Act 1911 stated: “...whereas it is intended to substitute for the House of Lords as it at present exists a Second Chamber constituted on a popular instead of hereditary basis, but such substitution cannot be immediately brought into operation”. Numerous other attempts have been made since the enactment of the 1911 Act to reform the upper chamber, the most noticeable (and successful, in terms of effect) being the House of Lords Act 1999. However, this was only intended as a ‘stop-gap’ measure, until agreement on more wholesale reform could be agreed. But there has been no widely accepted method of reform, resulting in the failure of many proposals in recent years, the latest being the House of Lords Reform Bill<sup>3</sup>, introduced to Parliament following the Draft Bill published in 2011<sup>4</sup> pursuant to the Coalition Agreement<sup>5</sup>. This article will explore the criticisms and strengths of the current arrangement; the most recent proposals for reform; and will analyse potential methods of reform moving forward.

## Current Arrangement

Like much of the British Constitution, and indeed the English common law, the House of Lords has developed in an incremental and incoherent fashion, often in response to political pressures of the day, as reflected in the statement of Lord Hailsham at the opening of this article. Thus, the House of Lords as it currently exists is generally regarded unsuitable in today’s society, and it is accepted that it is in need of reform. But before considering how the House should be reformed, it is first necessary to consider its weaknesses and strengths in its current guise, in order to inform how it should be changed.

## Criticisms

The overarching and dominant criticism of the current arrangement is its lack of democratic legitimacy. In a self-proclaimed democratic society, it seems odd that no member of the upper House of the UK legislature has been elected by popular vote to their seat.

Before going further, here may be an appropriate place to explore some of the changes made to the House of Lords over the last century, which may be seen to imbue, to a certain extent, the House with a greater degree of legitimacy. First, the Parliament Acts 1911 and 1949 restricted the power of the House of Lords to merely delay the enactment of any Bill, subject to only one exception regarding Bills extending the life of Parliament beyond 5 years<sup>6</sup>. Thus, the will of the democratically elected Commons can only be delayed, not overcome by the upper House. Second, the development of the Salisbury Convention from 1945 means that the manifesto commitments of the Government will not be opposed by the House of Lords, allowing for the relatively unhindered enactment of laws or schemes the public have voted for in a general election. Finally, perhaps the greatest reform in recent years, the House of Lords Act 1999 removed the majority of the hereditary peers from the House, making it a mainly appointed chamber, appointed by the Queen on the recommendation of the Prime Minister (for party-political peers) and the House of Lords Appointments Commission (an independent body, for non-party-political peers). Together these changes may be seen to lend the House with some degree of legitimacy, since peers there merely by virtue of inheriting title no

<sup>1</sup> Lord Bingham, ‘The House of Lords: Its future?’ [2010] PL 261

<sup>2</sup> Lord Hailsham, *On the Constitution* (Harper Collins, 1992), p48

<sup>3</sup> House of Lords Reform HC Bill (2012-13) [52]

<sup>4</sup> Cabinet Office, *House of Lords Reform Draft Bill* (Cm 8077, 2011)

<sup>5</sup> HM Government, *The Coalition: our programme for government* (2010), p27

<sup>6</sup> Parliament Act 1911, s2(1)



longer have the power to block legislation passed by the elected House of Commons (indeed, a great number of members of the upper House will now have been recommended by elected party leaders).

However, none of these reforms have given the House any sort of democratic legitimacy. But we must be careful not to conflate two separate issues: legitimacy and democracy. It may be submitted that the current House of Lords generally possesses a degree of legitimacy, in the sense that it acts within its constitutional role and is generally credible, carrying out a great deal of valuable work. What it does not possess is *democratic* legitimacy. This, for many, is the fatal flaw of the current arrangement. The mere appearance of unelected individuals being involved in law-making is seen by some as fundamentally unacceptable.

Another criticism commonly levelled is the presence as of right of 26 senior members of the Church of England. This is a complex and controversial subject, encompassing the establishment of the Church, and there is no space to explore the subject here, but perhaps the main issue is the relevance of including 26 bishops of the Church of England in the upper House of an increasingly multi-cultural and multi-faith society, with a declining proportion of the population identifying themselves as members of the Christian faith<sup>7</sup> by the mere fact of their office.

A final major criticism for the purposes of this article is the size of the upper House. Firstly, the House, with a current membership of about 780<sup>8</sup>, is much larger than any other upper legislative House within the developed world. For example, the United States Senate, regarded as one of the most powerful upper houses in the world, has only 100 members and represents a much larger nation than the UK. Even some of the world's largest upper houses, for example in Italy (326), France (321), or Spain (259), do not even come close to the *daily attendance* of the House of Lords<sup>9</sup>, even less its full membership. Why is it necessary to have such a large House to conduct its business? Indeed, with an average daily attendance of 475 members<sup>10</sup>, it may be that too many members with no or little knowledge of a given subject are participating in debates (or, more cynically, may be simply claiming attendance allowances for being present). This may be seen to undermine one of the advantages of the current House, its expertise, as will be discussed more below.

Second, there is no limit on the membership of the House. It seems strange that while the membership of the Commons is fixed, subject to changes to constituency sizes and numbers, there may be a theoretically unlimited number of Members of the House of Lords. Surely this feature is not an essential requirement for the House? Indeed, its size may be against the public interest, not least in terms of cost. True, some flexibility may be desirable to ensure sufficient levels of expertise and experience in the House, but this is not the same as an unfettered membership. It may be suggested that in some cases, peerages are granted as a method of recognition for contribution to society (or, again more cynically, political parties). It is submitted that, while peerage continues to be associated with membership of the House, this should not be the purpose of granting peerages, and such recognition should be achieved by other means, principally the honours system of MBEs and upwards, which has developed for this purpose.

## Strengths

As has been seen, there are several problems with the current arrangement of the House of Lords. However, the House does have some redeeming features, which must be borne in mind when considering any proposal for reform. It is clear that the principal role of the House of Lords at present, given the limitations on its powers, is as a revising and scrutiny chamber. It is the strengths of the current House which enable it to fulfil its functions to a high standard, and is generally highly regarded despite the perceived need for reform. First, perhaps the greatest strength of the current House is its degree of expertise. Many members appointed to the House are professionals who have had a distinguished career before entering Parliament. These range from lawyers and businesspeople to scientists and sportspeople. This pool of expertise, unmatched by the Commons (which features many 'career politicians' with little or no experience outside politics), allows

<sup>7</sup> Census 2011, Office for National Statistics, *Religion in England and Wales 2011* (2012)

<sup>8</sup> 2010-12 Parliamentary session (excluding those currently disqualified or on leave of absence), House of Lords Information Office, *Work of the House of Lords 2010-12* (2013), p29

<sup>9</sup> Bingham, 'The House of Lords: its future?' [2010] PL 261, p271

<sup>10</sup> 2010-12 Parliamentary session, House of Lords Information Office, *Work of the House of Lords 2010-12* (2013) p30



the House to undertake a better quality of scrutiny of legislation and Executive action than its elected counterpart. This is reflected in the highly regarded work of many of the Committees of the House of Lords: notably those concerning science, human rights, and constitutional matters; and the number of amendments tables in the Lords<sup>11</sup>. Further, but similarly, the fact that the members of the House of Lords often have a very different background to MPs in the Commons may be seen to enable it to provide a different perspective to issues when scrutinising legislation and Government activity. This may be regarded as a valuable asset of the current House, in that there is not simply duplication of the debate in the Commons. Secondly, the less partisan nature of the House of Lords is another of its great strengths. This is achieved by the fact that there is no overall majority of any political party, aided by the presence of 186 crossbenchers<sup>12</sup> with no political allegiance. This is further supported by the absence of elections, meaning members do not have to 'toe the party line' to be selected, and the secure tenure of seat. These factors mean that members are more at liberty to vote on the basis of their own personal views than their counterparts in the Commons, who are usually whipped to vote in line with their party, and it is less likely that a Bill or amendment will be blocked by one major section of the House. This relative freedom may be considered a benefit in reviewing legislation as it means a different perspective of issues may be forwarded, and there will not necessarily be large sections of the House following the views of perhaps only a few individuals, leading to a better quality of scrutiny.

Furthermore, the less partisan nature of the House of Lords also means that business of the House is less 'theatrical', compared with the Commons – as evidenced by the weekly Prime Minister's Questions, where MPs are often trying to make a good 'sound bite' for the next news bulletin, rather than take part in sensible, measured, and reasoned debate. Thus, more time is spent on detailed and worthwhile scrutiny and debate of legislation and the work of the Government.

We have seen that the current House suffers from a lack of democratic legitimacy, debate over the inclusion of senior clergy of the Church of England, and an unnecessary large size, whilst benefiting from a wealth of expertise and less partisan environment. The ideal reform would address all problems with the House, whilst retaining its strengths. But before considering possible ways the House could be reformed, it may be useful to outline the latest major proposals for reform.

### House of Lords Reform Bill (2012)

This article will not go into a detailed critique of the latest proposals. Rather, it may be useful to briefly outline the main features of the Coalition Government's proposals to provide some context for the later discussion on reforms.

The 2012 Bill, following the draft published in 2011, proposed replacing the current House with an eighty per cent elected chamber, with the remaining twenty per cent appointed by an independent appointments commission (plus ex-officio members). Elections to the House would be by a form of proportional representation<sup>13</sup>. The size of the reformed House would be reduced to a fixed number, four hundred and fifty, plus Lords Spiritual (but whose numbers would be decreased to 12), and any Member appointed so that they may hold Ministerial office<sup>14</sup>. The powers and functions of the House would remain the same, maintaining the primacy of the House of Commons<sup>15</sup>. Further, the association between peerages and the Upper House would be broken, so that peerage does not confer membership of the House and vice versa<sup>16</sup>.

The Bill was introduced to the House of Commons in June 2012, but was withdrawn by the Deputy Prime Minister in September 2012 amid political opposition, significantly from the backbenches of the Conservative Party<sup>17</sup>.

11 10,031, of which 2,496 were passed in the 2010-12 Parliamentary session, House of Lords Information Office, *Work of the House of Lords 2010-12* (2013) p2

12 2010-12 Parliamentary session, House of Lords Information Office, *Work of the House of Lords 2010-12* (2013) p29

13 House of Lords Reform HC Bill (2012-13) [52], sch 3

14 House of Lords Reform HC Bill (2012-13) [52], cl 1

15 House of Lords Reform HC Bill (2012-13) [52], cl 2

16 House of Lords Reform HC Bill (2012-13) [52], cl 1(4)

17 See Bowers, *House of Lords Reform Bill 2012-13: decision not to proceed* (House of Commons Library, SN/PC/06405); also 'Nick Clegg



### **So where now?**

As discussed above, there are both positive and negative aspects to the current House of Lords, and there is general agreement that it's in need of reform. However, there is no straightforward method of reform for the House which is widely accepted.

### ***An elected House?***

As seen above, perhaps the principal perceived problem with the current House is its lack of democratic legitimacy. As a response, one of the main reform proposals, and indeed the most recent, has been for an elected (or mainly elected) House. This would address the democratic deficit of the House of Lords, but brings with it several more problems, which, it is suggested, would go some way to counter-act the benefit gained, and also diminish the present positive aspects of the House.

The first problem of an elected House will be the increased strength that the reformed House will have. The democratic legitimacy of an elected House means it may be more willing to stand up to the House of Commons. Indeed, if a proportional mode of election was adopted for the upper House, it may even be regarded as possessing *more* democratic legitimacy than the Commons. The upper House may come to assert its power to delay legislation more often than it commonly does. This would inhibit the effective functioning of government, and may mean that the Government is less able to implement its key policies. Thus, ultimately, the public interest would be harmed as Executive policy and decision making would be hindered by a more assertive House.

Second, there is a risk that the current strength of the House of Lords in its functions of scrutinising legislation and Executive action may be jeopardised by an elected House, for several reasons. Firstly, the House would be more likely to become dominated by political parties. Like general elections for the Commons, it is likely that candidates for election will want to be supported by a political party; and the public are more likely to vote for those with party affiliations. This will have the result that the upper House becomes more partisan, inhibiting the reformed House from effectively scrutinising Government action and legislative proposals, as more members to 'toe the party line', and analysis will likely come to replicate the Commons. Further, there is a risk that professional individuals will not be prepared to stand for election (or, if they do, stand without the backing of a political party, which emphasises the previous problem). One of the strengths of the current House is the presence of a large number of individuals who previously had distinguished careers before entering Parliament, thus providing the House with a wealth of knowledge and experience. An elected House, however, in the words of Professor King, 'would inevitably consist almost entirely of a miscellaneous assemblage of party hacks, political careerists, clapped-out retired or defeated MPs, has-beens, never-were's and never-could-possibly-be's'<sup>18</sup>. This would detract from the level of expertise of the House in a range of areas, making it less well-equipped to fulfil its functions as well as it presently does. Combined, these are serious flaws which surely, in the opinion of this author, must mitigate against the introduction of either a wholly or mainly elected upper House. So, what are the other options?

### **A unicameral system?**

As Lord Bingham pointed out<sup>19</sup>, two thirds of the world's legislatures are unicameral<sup>20</sup>. These include countries such as New Zealand, Sweden, and Norway, generally considered stable and well-governed. Though such an approach has been proposed numerous times in the past, in recent years it has fallen out of favour with those who seek reforms to the system. Though it would undoubtedly remove the issue of the involvement of a wholly unelected institution in the law-making process (by abolishing it outright), this is also its fatal flaw.

It is a common view among constitutional lawyers that the House of Commons, and Parliament more

confirms Lords reforms have been officially withdrawn' (*BBC News*, 3 September 2012) <<http://www.bbc.co.uk/news/uk-politics-19463780>> accessed 28 February 2013

<sup>18</sup> King, *The British Constitution* (Oxford, 2007) p310, apostrophes as published

<sup>19</sup> Bingham, 'The House of Lords: its future?' [2010] PL 261, p268

<sup>20</sup> i.e. having only one legislative chamber





generally in its current form, is unable to effectively scrutinise the work of the Executive<sup>21</sup>. This has several causes, which, it is argued, are mitigated by the presence of the House of Lords. First, perhaps one of the most significant problems is the dominance of the governing party in the Commons. Since the Government is drawn from the majority party of the Commons (or, like now, a coalition commanding a majority of the House), the Government effectively controls the House. Thus, by the practice of whipped votes, the Government is able to pass most of its proposals through the House of Commons, with defeats of Government votes rare<sup>22</sup>. Whilst most Government Bills are also passed in the House of Lords, the less partisan nature of that House, with no overall majority of any party, means that more votes are defeated<sup>23</sup>, and even where they are not, members are voting more on the basis of their own views than those of their party. A further inhibition of effective scrutiny in the House of Commons is the lack of Parliamentary time, and the control of most of this time by the Government. The work of modern Government is extremely complex and varied, all of which could not be fully scrutinised even if the whole of Parliamentary time was dedicated to so doing. There is also insufficient time for scrutinising legislation on the floor of the House of Commons. The Government may, especially in relation to more controversial legislation, or that it wishes to pass quickly, allocate little time for debate of a Bill in the House, allowing for little more than debate of the general policy behind it. On the other hand, the House of Lords spends much more time conducting careful scrutiny of legislation, and tables many amendments, often improving the quality of legislation enacted by Parliament. Thus, if the House of Lords were to be abolished outright with no replacement, the level of scrutiny that Parliament would be able to expose legislation and governmental action to would be severely reduced, and this can only be a negative development.

### Is reform really necessary?

So far, this article has asserted that the House of Lords is generally regarded as in need of reform. It has identified some significant problems with the current House, but also some great strengths. Indeed, despite the shortcomings of the current House, it is generally thought that it performs its functions very well in its current guise. Thus, is a reform of the House really needed? Lord Hailsham<sup>24</sup> distinguished between two classes of human institution: the traditional and the contrived. He then stated: 'The contrived must be judged by reason. The test of the traditional type is how well it works in practice and the quality and value of what it produces.' The current House is an example of the traditional type, whilst a reformed House would be an example of the contrived. The main function of the current House is to revise legislation and scrutinise legislation. The outcomes of the House of Lords' work in carrying out these functions is widely considered to be good quality, and is highly regarded as a counterweight to the more powerful Commons. This would seem to mitigate against significant reform of the House.

However, this may be to underestimate the significance of perception in a society with no written, or even clearly defined, constitution. Since there is no clearly defined constitutional structure in the United Kingdom, unlike in other countries, such as the US, where the powers of the branches of government and of the different organs of the legislature are defined in the Constitution, much depends on practice and perception. The general populous may not appreciate fully the actual powers of the House of Lords (i.e. that it cannot veto legislation), and therefore simply regard it as an unelected House making law, which may be seen by some as fundamentally unacceptable. Notwithstanding this, as has been seen above, there are several other problems with the current House. The continuing inclusion of 92 hereditary peers<sup>25</sup> is unacceptable, undermining any legitimacy the House has, as members are not there by virtue of any knowledge, skills, or experience they have, but rather by virtue of a title they have inherited. Further, the large size of the House and, arguably, the inclusion of so many Church of England bishops are also unacceptable and should

21 See, for example, Elliott and Thomas, *Public Law* (Oxford, 2011), ch 10

22 The current Government, under Prime Minister David Cameron, has lost only 2 votes in the House of Commons since coming to office.

23 There have been 14 government defeats in the 2010-12 Parliamentary session, 'Government defeats in the House of Lords' (*UCL Constitution Unit*) < <http://www.ucl.ac.uk/constitution-unit/research/parliament/house-of-lords/lords-defeats> > accessed 4 March 2013

24 Lord Hailsham, *On the Constitution* (Harper Collins, 1992), p51

25 House of Lords Act 1999, s2





not remain a feature of the UK's constitutional arrangements. Therefore, at least some form of reform is necessary.

### **An alternative?**

As we have seen, any reform of the House of Lords needs to do several things: (1) to be generally acceptable it must address the main issue of the current House – its perceived lack of democratic legitimacy; (2) it must preserve the expertise of the current House, which is essential to its ability to effectively scrutinise both legislation and Executive action and therefore the purpose of the House; and (3) it must avoid becoming too partisan, which would inhibit its effective function, and counteract its current strength in not simply following party lines. It may be considered that a further requirement of a reformed House would be to avoid imbuing it with a strength which may come to challenge the Commons, which would require a more fundamental rethinking of the UK's Parliamentary system. As has been discussed above, the principal and most commonly found proposals from those concerned with the House's reform all have flaws, and do not meet the three requirements just set out. Thus, it may be necessary to consider a completely different mode of reform for the upper House.

A more drastic method of reform may be to remove the legislative functions of the House outright. The discussion here will start with an overview of Lord Bingham's proposal of a 'Council of the Realm'<sup>26</sup>. The basis of Lord Bingham's proposal is the removal of the legislative powers of the present House. The newly formed Council would have the same reviewing powers over legislation, though amendments would take the form of recommendations which the Commons would then be under a statutory obligation to consider. The Council would also encompass several specialist committees, similar to the current House of Lords Committees, and would perform much the same functions. The main differences, other than lack of legislative powers, include a wholly appointed membership (though Lord Bingham proposed that the initial Council would be made up of almost all existing members of the current House); an ultimately reduced (though not fixed) membership; and the removal of hereditary seats. Further, members of Council would not be entitled nor required to attend all sessions, reflecting the fact that the large attendance of the current House is unnecessary. Rather, legislative committees would, on Lord Bingham's proposal, consist of around twenty to twenty-five members, whilst the membership of specialist committees would be smaller still. On the whole, it is suggested that this proposal is very acceptable. With reference to the criteria set out at the beginning of this section, a new Council would (1) address the current issue of an unelected House of Lords being directly involved in law making, by removing all direct legislative power from an unelected body; (2) the Council would maintain the level of expertise which characterises the current House, through appointment of qualified and experienced individuals; and (3) through appointment of members, rather than election, the political divisions of the Council could be controlled. This author would suggest that, on the basis that wholesale reform of the House of Lords is necessary, an approach modelled on Lord Bingham's structure would be the most desirable for addressing the problems of the current House, whilst retaining its redeeming features.

Therefore, using Lord Bingham's proposal as a starting point, it is suggested that an acceptable and welcome reform of the House may take the following form (here Lord Bingham's use of 'Council' will be adopted for ease):

1. The Council would be separated from Parliament with no direct legislative powers (save in respect of Bills extending the life of Parliament, which would require the approval of a majority of the full Council to prevent abuse of power by the House of Commons<sup>27</sup>), thus answering the criticism of an unelected House directly making law.
2. The Council would retain the legislative revising function of the current House, one of its great strengths – though the Council would not be able to amend the legislation directly, but instead make recommendations to the Commons, who would be statutorily obliged to consider them (and, likely to

<sup>26</sup> Bingham, 'The House of Lords: its future?' [2010] PL 261

<sup>27</sup> Bingham, 'The House of Lords: its future?' [2010] PL 261, p273



be politically expected to accept them, unless it has good reason for otherwise).

3. Legislation would be considered by legislative committees, rather than the full Council. It is posited that such committees would be made up of twenty to thirty members, with a required minimum number of members with specialist expertise in the subject concerned (perhaps one quarter), and a minimum number of lawyers (either practiced or academic) to ensure legal coherence (perhaps two to three members), and one of this required group would chair the committee; whilst the remainder would be made up of other Council members either by appointment (by a committee chair, for example) or nomination.
4. The Council would also form permanent specialist committees, likely to mirror the existing House of Lords Committees, to review Executive action and policies more generally. These would be made up of, perhaps, around fifteen members, again a minimum of whom would be expected to have knowledge of the relevant subject (perhaps half, given the specialist nature of the committees). This would preserve another great strength of the current arrangement.
5. All members would be appointed by an independent appointments commission. The commission would be expected to maintain a range of expertise and experience among the members of the Council, and also ensure representation of all major political and cultural views in Council (though with no overall majority of any one, and it is expected that there would still be a significant element with no political allegiance). Peerage would not be conferred on members, as proposed in the latest Government proposals.
6. Members would serve until a set retirement age (above the general retirement age, to allow for the inclusion of retired professionals). Otherwise, members may resign from the Council, and members may be removed for misconduct or for committing a criminal offence, or following a resolution of the full Council.
7. The size of the Council would be reduced, perhaps to around four hundred. However, in order to retain flexibility and ensure the inclusion of necessary expertise in Council, there would not be a strict limit on its size, but a target number.
8. Though the business of the Council will normally be conducted by committees, it would be possible to call a session of the full Council where an issue of fundamental importance is under debate (for example, major constitutional change), or where necessary for the administration of the Council (for example, to expel members). The House of Commons may also request a meeting and resolution of full Council if it thinks it appropriate.
9. The Council would enjoy the immunities and privileges enjoyed by the House of Commons, and so for such legal purposes, would still be considered an organ of Parliament. Further, all committees would enjoy the same powers of the current House to summon Ministers and public officials to give evidence.
10. It is expected that the Council may still form Joint Committees with the House of Commons, and these would continue to enjoy Parliamentary status where appropriate.
11. Senior clergy of the Church of England would no longer hold a seat in the Council as of right. However, they may be appointed as part of the normal appointments process. Senior members of other religions would also be eligible for appointment. However, it is expected that these appointments would be made personally, so that members hold their seat in their own right, rather than by virtue of their office.



## Conclusion

It is clear that in light of the current House of Lords' weaknesses, it is in need of reform. What is much less clear is how it should be reformed. This article has analysed several possible ways of doing so, including perhaps the most dominant (within the political arena, at least) view, that of creating an elected House. However, it has been seen that there are serious problems with such a proposal. Instead, this article has proposed a solution which would address the most significant issues with the current House, whilst retaining its redeeming features.

The practicalities of implementation of a reform of the House must, however, be borne in mind. Given the recent failure of a major scheme of House of Lords reform, it is unlikely that another proposal of such scope will be brought forward soon. But changes to the House should not be abandoned, and indeed remedying some smaller defects of the current House may make it easier to pass a new scheme in due course. This may involve removing the remaining hereditary element of the House, making it a wholly appointed chamber. Also, removal of the inclusion of Church of England bishops as of right, or at least a reduction in their number, may be considered a welcome development. Increased public awareness of the work of the House, its powers, and its contribution to the legislative process and scrutiny of Government action would also be welcome, to facilitate informed debate and challenge any misconceptions that may exist that the House has the power to permanently prevent legislation or Government policies being implemented.

Overall, the House of Lords is a rather odd institution, which has developed with small changes to its powers or composition over many years. It has been the subject of political debate for over a century, and yet, considering that there is no general consensus on how to move forward, it is likely to continue to be so for many years to come. We should not, however, underestimate the great strengths of the current upper House and the value of the work it carries out; it is far from being completely unsatisfactory in its present form.



# **Negotiation and Mediation: Promoting a Culture of Injustice?**

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## I. Introduction

There is something remarkably attractive about the idea of being the master of your own fate. Something even more attractive is influencing that of others. Small wonder then that processes like negotiation and mediation, in which the parties resolve their differences on their own terms, have universally come to occupy a central position in dispute resolution and are slowly but surely substituting litigation processes world over. Few people find something to criticize about them. Even fewer muster the courage to openly condemn these well-beloved practices.<sup>1</sup> I would not be so bold as to choose to be one of the latter; however, I shall choose not to pass over this opportunity to voice some concerns about the disadvantages implicit in them, with respect to the perennial theme of 'justice' in negotiations.

It would probably be prudent here to first mention the core element that characterizes negotiations and mediations for what they are - the self-resolution of disputes by the parties to the dispute - meaning thereby that the solution is conceived by the mutual agreement of the parties themselves, without resorting to a third party for the same. Even where mediations proceed with the occasional intervention of a third party mediator, the intervention is strictly confined to facilitating the dispute resolution (perhaps in terms of smoothing out tension or precisely identifying the problematic areas) and does not extend to imposing the solution on the parties, the determination of which is the exclusive domain of the parties alone. It is crucial to bear this characteristic in mind, for the article hinges predominantly on a proposition that motivations of self-interest and privatization of the solution are the critical factors that lead to a denial of 'justice' in negotiations.

The concepts of 'fairness' and 'justice' have always been an indispensable part of negotiation and mediation literature. Hundreds of books are filled with accounts of distributive and procedural fairness, and innumerable empirical studies have attempted to discern descriptive and normative answers to micro-ethical questions of how, when, why and what perceptions of fairness colour, or should colour, the disputing parties' decisions. Thus, the premise of the discussions has primarily been the *parties' perceptions* of what is fair, and not an independent opinion.

In this paper, I intend to address a macro-ethical question, one that does not seem to have been very widely advocated or explored,<sup>2</sup> "Is real 'justice' inhered in the results of negotiation proceedings?"<sup>3</sup> An incidental question logically follows, "Does the parties' mutual agreement justify the 'justness' of the solution?" What this paper will essentially posit is that negotiations and mediations may in most cases not yield a 'just' result, one that will satisfy an objective benchmark of justice, removed from what the parties may subjectively and contextually consider as 'fair'. 'Justice' is a transcendental objective standard, as opposed to 'fairness', which

<sup>1</sup> See generally Fiss, O.M. 'Against Settlement' (1984) 93 Yale Law Journal 1073. He is possibly the most vociferous non-supporter of ADR processes and is well-known for his corrosive remarks on the disadvantages of negotiations and mediations. His paper argues that the litigation process is better than negotiations and this is what ought to be followed by the society.

<sup>2</sup> Cecilia Albin, 'The Role of Fairness in Negotiation' (1993) 9 Negotiation Journal 223. Albin explains that an agreement reached during negotiations is viewed as the outcome of a contest, not a judgment on the fairness of the solution. This viewpoint explains the scarcity of literature on the issue of "justice", since there is no research base on which one could build such knowledge.

<sup>3</sup> In this respect, I question the justness of the solution based on the outcome of the negotiation or mediation as decided by the parties. The mediator's role, his neutrality concerns and his obligation to third parties or to the achievement of objective justice is not within the scope of the paper.





is simply 'justice in context' i.e justice as conceived by the parties depending on their circumstances. This subtle distinction made between "justice" and "fairness" will have to be borne in mind throughout the length of this paper, since the primary argument advanced here is based on the non-conformity of a 'fair' solution with a 'just' solution.<sup>4</sup> This paper will also consider why it is crucial to address such a heightened sense of justice, in anticipation of a potential argument that practically negotiation is personal to the two parties and third party considerations of justice shouldn't matter so long as the disputing parties are amenable to the solution. A comparison between litigation and negotiation becomes necessary in this regard, although this should not be understood to mean that the author is suggesting that litigation is *per se* a better alternative.<sup>5</sup> The attempt in this paper is not to aggrandize any form of dispute resolution but simply to dispel the general notion that negotiations and mediations are intrinsically good. The scope of this paper is limited to raising the problems associated with 'justice' (or the lack thereof) in negotiations. A much wider and more in-depth study will be required to provide solutions to these problems and will consequently not be dealt with in this paper.

## II. The much-acclaimed negotiation and mediation route

Discourage litigation.

Persuade your neighbours to compromise whenever they can.

Point out to them how the nominal winner is often a real loser

-in fees, expenses and waste of time

- Abraham Lincoln

"Private settlements are the norm, not the exception" in contemporary American legal culture, and popular support for this trend is presumed.<sup>6</sup> Almost every part of the civilized world is witnessing an exponential increase in the number of negotiations and mediations. There are undoubtedly several elements to the credit of ADR settlements – their inexpensive nature, the speed, the maintenance of anonymity, and control of the eventual outcome which is mutually gainful. In this context, a comparison with litigation is virtually inescapable. "The generic image of ADR is perceived to be friendly, flexible, and nicer than the uncivil exchanges that characterize litigation, and the processes are viewed as offering the opportunity for accommodation, and with it an escape from the win/loss hierarchy."<sup>7</sup> Litigation holds an almost "jaundiced view"<sup>8</sup> as being "expensive,

4 Cecilia Albin, 'The Role of Fairness in Negotiation' (1993) 9 Negotiation Journal 223, 225; Michelle Maiese, 'Principles of Justice and Fairness', *Beyond Intractability* (July 2003) <[http://crinfo.beyondintractability.org/essay/principles\\_of\\_justice/?nid=1012](http://crinfo.beyondintractability.org/essay/principles_of_justice/?nid=1012)> (accessed 5 June 2012). It is exactly the distinction between justice and fairness that Michelle Maiese and Cecilia Albin draw in their papers. Though the two terms, justice and fairness, are generally used interchangeably, justice is considered to be transcendental, it is a normative standard, born out of a general social consensus as to what is right. Fairness is justice in context, where parties concerned with fairness typically strive to work out something comfortable and adopt procedures that resemble rules of a game. According to Albin "Negotiators naturally tend to view and refer to their own fairness norms as "justice" -- as criteria reflecting some higher ethics going beyond partisan perceptions, interests, and situational factors".

5 Unlike Fiss, I do not adopt a stand that negotiations are *per se* evil. Justice dispensation is one of the fundamental problems that arise in negotiation cases which is why it becomes important to raise it. This doesn't amount to a proposition to dispense with settlements all together. Questions like how to resolve this problem, whether this problem can be resolved at all, whether negotiations ought to be done away with, or whether they need to be confined to certain situations specifically are too complex, the answers to which is beyond the scope of this paper.

6 Owen Fiss, *The Law as it Could Be* (New York University Press, 2001) 53; Deborah L. Rhode, *Access to Justice* (Oxford University Press, 2004) 42.

7 Christine B. Harrington, *Shadow Justice: The Ideology and Institutionalization of Alternatives to Court* (Greenwood Press, 1985) cited in Don Ellinghausen, Jr. 'Justice trumps Peace: The Enduring Relevance of Owen Fiss' *Against Settlement*' available at < <http://pegasus.rutgers.edu/~rcrlj/articlespdf/ellinghausen.pdf>> (accessed 6 June 2012).

8 Marc Galanter, 'The Hundred-Year Decline of Trials and the Thirty Years' War' (2005) 57 Stan. L. Rev. 1255, 1269.



terrifying, frustrating, infuriating, humiliating, time-consuming, perhaps all-consuming”.<sup>9</sup> We live in an age where “lawyer-bashing has become a national hobby, lawsuits a lightning rod for talk show *resentniks* and the civil system a cherished target of rage and demagoguery”.<sup>10</sup> Supreme Court judges, reform-minded legal scholars and business elites alike have decried the legal system and besieged people with claims of a “Litigation Crisis”, chalking out an endless list of castigations against adjudication.

A perceptive observation of the movement indicates that the momentum is actually in a direction away from litigations, whatever that direction may be, rather than a direction towards ADR. Continuing criticisms of the pace, expense, and tenor of adjudication illustrate that “the doors to ADR are opened because the door to superior court is perceived either to be functionally closed or slightly ajar.”<sup>11</sup> Therefore, it is clear that the depreciating picture of litigation painted by people is what actually fuels the drive towards ADR, as opposed to the merits of ADR itself. The trend “has the tone of cultist conversion, religious fervour, or infatuation with all that is not litigation”;<sup>12</sup> one simply does not stop to question whether they are indeed the right thing. The reaction to negotiations and mediations is not very different from the unthinking reaction of a child who is so enamoured by a new-looking toy that he does not even bother to check if a hand or a leg is missing. The presumption that these dispute resolution methods are infinitely preferable, and preferred, over adjudications “is so ingrained in contemporary legal culture that it is rarely questioned.”<sup>13</sup>

However, in 1983, Derek Bok’s<sup>14</sup> report to the Harvard Overseers, suggesting that legal education should reduce the emphasis on adversarial litigations and instead advocate “the gentler arts of reconciliation and accommodation”<sup>15</sup> sparked the beginning of an anti-negotiation movement. One man had the nerve to take on a growing tide of universal popularity in favour of alternative dispute resolution mechanisms. Discarding all restraint, Owen Fiss fearlessly delivered a corrosive critique on private settlements, arguing that there was no cause for celebration in them, since they fundamentally defy public values.<sup>16</sup> His cause was gradually taken up by other jurists like David Luban, Amy Cohen, Don Ellinghausen and others, who discovered the hidden pitfalls in settlement processes. These observations notwithstanding, settlement practices have continued to garner immense support. The time seems ripe for another “Fissian” attempt on these practices.

This article is a humble effort on the part of the author to demonstrate that not everything about negotiations and mediations is as rosy as the picture that is painted of them seems to project. The question of ‘justice’ never figured prominently in the picture; it was simply presumed that negotiations and mediations provide an cheaper and time-bound alternative route to access justice, which resulted in the practical aspect of money-and-time-

<sup>9</sup> David Luban, ‘Settlements and the Public Realm’ (1995) 83 Geo Law Journal 2619, 2621.

<sup>10</sup> *Ibid.*

<sup>11</sup> Judith Resnik, ‘Many Doors? Closing Doors? Alternative Dispute Resolution and Adjudication’ (1995) 10 Ohio State Journal on Dispute Resolution 211, 246.

<sup>12</sup> Jeffrey Stempel, ‘Forgetfulness, Fuzziness, Functionality, Fairness and Freedom in Dispute Resolution: Serving Dispute Resolution through Adjudication’ (2002) 3 Nev. L. J 305, 309.

<sup>13</sup> Deborah R. Hensler, ‘Suppose it’s Not True: Challenging Mediation Ideology’ (2002) J. Disp. Resol. 81, 83.

<sup>14</sup> Derek Bok was the 25<sup>th</sup> President of Harvard University, which was the first university in America to house a full-fledged clinic course on negotiations and mediations.

<sup>15</sup> Derek Bok, ‘A Flawed System’, HARVARD MAGAZINE, May-June 1983, 38, excerpted at Derek C. Bok, ‘A Flawed System of Law Practice and Training’ (1983) 33 J. Legal Educ. 570.

<sup>16</sup> Owen Fiss, ‘Against Settlement’ (1984) 93 Yale Law Journal 1073, 1085.



saving receiving the king's share of the attention, while justice was relegated to a idealistic non-entity.

## I. Neglect of objective justice in negotiations

### 1.1 Negotiation outcomes ignoring third party interests

Literature on fairness in negotiations is replete with fairness concerns from the point of view of the participating parties. When one does peel their eyes away from the lure of private settlements, the broader picture exposes a wide expanse of seemingly hidden anti-negotiation literature scrutinizing the 'justice' angle from other varying standpoints. However, their worth has mostly denigrated under the immense weight of the pro-negotiation ADR discourse supported by negotiation enthusiasts, which has enamored the masses simply by appealing to their selfish natures. In spite of this, a number of bolder theorists have addressed the overarching morality issues that pervade negotiations, striking at the very core of the negotiation process by questioning its inherent ethicality.<sup>17</sup> The biggest resistance to an argument such as the one advanced here, and one of the possible reasons why this approach hasn't garnered substantial support in negotiation literature, is its counter-intuitiveness. Privity and confidentiality being core attributes of negotiations, there is a tendency to privatize negotiations and the resultant settlement to the two parties, fostering the belief that a consensus-driven outcome is as 'just' as can be.

This characterization has however, come under fire in light of the growing number of negotiations related to public and social issues like divorce, environmental issues, land acquisition, ethnic conflicts, labour, public policy, and so on, which inflict "public bads"<sup>18</sup> on third parties. The question of whether mediation is used "to translate social problems into individual problems and structural concerns into psychological issues" has been specifically raised by Mayer.<sup>19</sup> Consider how children become the targets in a divorce negotiation,<sup>20</sup> future generations are affected by settlements on environmental dispute,<sup>21</sup> similarly situated claimants are affected in mass torts settlements,<sup>22</sup> consumer rights cases affect subsequent claimants or even how public policy settlements such as negotiations on health, safety and social welfare issues can affect citizens at large.<sup>23</sup> One perfect example of such influence on third-parties was the Bhopal Gas Tragedy settlement in India.<sup>24</sup> The shocking settlement of a meagre \$470 million, reached between the Government of India and the Union Carbide Corporation ("UCC"), in return for all legal liabilities against the UCC being dropped, was in

17 Stuart Hampshire, *Justice is Conflict* (Princeton University Press, 2000); Jon Elster, 'Strategic Uses of Arguments', in K. Arrow *et al*, *Barriers to Conflict Resolution* (Norton, 1995); Forester, *The Deliberative Practitioner: Encouraging Participatory Planning Processes* (MIT Press, 2001), cited in Carrie Menkel-Meadow, 'Introduction', in Carrie Menkel-Meadow and Michael Wheeler (eds.), *What's Fair: Ethics for Negotiators* (1st ed., Jossey-Bass, 2004) XVII.

18 Owen Fiss, 'Against Settlement' (1984) 93 Yale Law Journal 1073.

19 Bernard S. Mayer, *Beyond Neutrality: Confronting the Crisis in Conflict Resolutions* (1st ed., Jossey-Bass, 2004) 99.

20 Wallerstein and Kelly, *Surviving the Breakup: How Parents and Children Deal with Divorce* (Basic Books, 1980), cited in Carrie Menkel-Meadow and Michael Wheeler (eds.), *What's Fair: Ethics for Negotiators* (1st ed., Jossey-Bass, 2004) XVII.

21 Susskind, 'Environmental Mediation and the Accountability Problem' (1981) 6 Vermont Law Review 85, cited in Carrie Menkel-Meadow and Michael Wheeler (eds.), *What's Fair: Ethics for Negotiators* (1st ed., Jossey-Bass, 2004) 367.

22 Carrie Menkel-Meadow and Michael Wheeler (eds.), *What's Fair: Ethics for Negotiators* (Jossey-Bass, 1st ed., 2004) XVII.

23 David Luban, 'Settlements and the Public Realm' (1995) 83 Geo Law Journal 2619, 2621; Carrie Menkel-Meadow, 'Public Access to Private Settlements: Conflicting Legal Policies' (1993) 11 Alternatives 85, cited in Carrie Menkel-Meadow and Michael Wheeler (eds.), *What's Fair: Ethics for Negotiators* (1st ed., Jossey-Bass, 2004) 367.

24 Union Carbide Corporation v The Union of India and Ors, AIR 1989 SC 273.



flagrant disregard of the intergenerational effects of the toxic accident. The estimate was widely criticized for having completely wiped out considerations of the potential effect of the accident on the future generations.<sup>25</sup> Effectively, the two parties engaging in the resolution reached a successful conclusion by shifting its burden to the third party.<sup>26</sup> The idea that every major party to a conflict, or groups most affected by the outcome, should be given a genuine opportunity to be represented in the negotiations is regarded as a key element of justice, something that most negotiations mysteriously ignore.

The above illustrations arise in the context of negotiations disregarding directly identifiable social impacts on third parties, wherefrom arises both the injustice itself, and the justification for societal intervention. For the sake of argument let us assume that private agreements do exist, where there is no such 'direct' social impact of the outcome. Where does the injustice arise from in such negotiations?

In actuality, negotiations which do not involve public issues *per se* nonetheless take place in a social construct and invariably spill over into the public realm, affecting a whole host of people and things<sup>27</sup> like investors in private commercial deals;<sup>28</sup> taxpayers, other employees (for instance, in an acquisition), vendors, clients<sup>29</sup> and fellow citizens;<sup>30</sup> all of whom are impacted by 'apparently' private negotiations. In a recently concluded negotiation in Singapore, an Indian family agreed not to cook curry at their house because the smell of the curry irritated the neighbours. *Prima facie*, it may seem like a personal decision of the parties meriting no interference, but its disclosure triggered an instant uproar about civil liberties.<sup>31</sup> Another issue worth citing is the land acquisition debate that has plagued the Indian society for years together. The Government, while negotiating with minorities for land acquisition, uses its power and financial resources to persuade them to part with their land. Though the minorities may willingly agree in return for the monetary gain, there is always a public debate that erupts about this being a denouncement of fundamental rights.<sup>32</sup>

## 1.2 Structural transformation rather than dispute resolution

The preceding sub-section espoused the problem of negotiations which involve a third-party whose concerns were not accounted for in the proceedings. This sub-section will take it a step further by revisiting the argument advanced by Fiss, and later taken up by David Luban - the woeful inability of settlements to effect a structural

25 Dinesh C. Sharma, 'Bhopal Gas Tragedy: Government, Union Carbide struck secret deal post leak', *India Today* (25 July 2011) <<http://indiatoday.intoday.in/story/bhopal-gas-tragedy-union-carbide-india-deal/1/146044.html>> (accessed 4 June 2012). Public protest against the unjust settlement, followed by the filing of a number of review and writ petitions against the settlement in the Supreme Court by the Bhopal Gas Peedith Mahila Udyog Sangatan (BGPMS), the Bhopal Gas Peedith Sangarsh Sahayog Samiti (BGPSSS) and other concerned groups clearly demonstrated the justice concerns that necessarily arise in even in such so-called private settlements.

26 David Luban, 'Settlements and the Public Realm' (1995) 83 *Geo Law Journal* 2619, 2626.

27 Carrie Menkel-Meadow and Michael Wheeler (eds.), *What's Fair: Ethics for Negotiators* (1st ed., Jossey-Bass, 2004) 367.

28 Langevoort, 'Half Truths: Protecting Mistaken Inferences by Investors and Others' (1999) 52 *Stanford Law Review* 87, cited in Carrie Menkel-Meadow and Michael Wheeler (eds.), *What's Fair: Ethics for Negotiators* (1st ed., Jossey-Bass, 2004) XXVII.

29 Carrie Menkel-Meadow, *ibid*, XVI.

30 Derek Bok, *Lying: Moral Choice in Public and Private Life* (Pantheon, 1978), cited in Carrie Menkel-Meadow and Michael Wheeler (eds.), *What's Fair: Ethics for Negotiators* (1st ed., Jossey-Bass, 2004) XVII.

31 Malcolm Moore, 'Singapore's 'anti-Chinese Curry War'', *The Telegraph* (16 August 2011) <<http://www.telegraph.co.uk/news/worldnews/asia/singapore/8704107/Singapores-anti-Chinese-curry-war.html>> (accessed 30 May 2012)

32 Sharma, E.A.S. 'Money doesn't make the Landowner fonder', *Tehelka* (6 August 2011) <[http://www.tehelka.com/story\\_main50.asp?filename=Ws060811Money.asp](http://www.tehelka.com/story_main50.asp?filename=Ws060811Money.asp)> (accessed 4 October 2011); Azadi Bachao Andolan and Ors v State of UP and Ors AIR 2003 All 290.



reform in the society. Therefore, it isn't just one identifiable third person or one identifiable class of persons who suffer the consequences, but the nameless faceless public as a whole.

Fiss contemplates the formal legal system in two ways - as an instrument for structural reform, and as a forum for dispute resolution.<sup>33</sup> The legal system was wielded by judges to bring structural transformation in the society in the 1930s. During the 1970s however, this growth was halted by the resurgence of the dispute resolution model owing to the "ever increasing ascendance of market economy".<sup>34</sup> The judge came to be viewed as nothing but "the institutionalization of the stranger, to which the quarrelling neighbours had turned to resolve their dispute, the authority of the judiciary is linked to the consent of the quarrelling neighbours".<sup>35</sup> Fiss advocated a more radical interpretation where the judiciary is seen as something beyond an authority to simply settle disputes; they were the perpetrators of a more fundamental order in the society, labouring to create a balanced and just society.

Dispute resolution is not confined to just a narrow-minded ultra-practical approach of resolving a private dispute. It has much broader objectives.<sup>36</sup> As Fiss explains, "Courts exist to give meaning to our public values, not to resolve disputes".<sup>37</sup> But when minorities are given concessions during negotiations, it is only a momentary truce for the purposes of resolving the issue; there is no structural ideological conversion or empowerment that is occasioned.<sup>38</sup> Negotiation and mediations have rarely been viewed from the "rights" angle. The theme was conspicuously ignored even in the policy discussions on ADR. According to Christine Harrington "In the alternatives movement legal resources are not rights, they are institutions to facilitate negotiation and mediation." The emphasis is on settling the dispute, not protecting rights.

One needs to remember that we live in a world where one cannot pre-suppose roughly equal bargaining power of the parties; oppression by the institutions like the government, corporations and big business houses (in employment disputes for instance) amongst others necessitates the intervention of an impartial authority to restore the balance. Fiss' enduring question to illustrate this proposition remains "Where would we be if *Brown v Board of Education* had been settled quietly out of court?"<sup>39</sup> Although the parties may have lived in tolerable peace had the matter been privately settled, the question of racial equality would have remained unanswered for perhaps another quarter of a century. The broader and far-reaching consequences of a judgment of such nature, unconfined to that case alone, is what goes amiss, if one chooses to settle such matters. This translates

33 Owen Fiss, 'The Social and Political Foundations of Adjudication', (1982) 6 *Law and Human Behavior* 121, 122-24; Owen Fiss, 'Two Models of Adjudication', in R. Goldwin and W. Schambra (eds.), *How does the Constitution Secure Rights?* (Aei Press, 1985).

34 Amy J. Cohen, 'Revisiting Against Settlement: Some Reflections on Dispute Resolution and Public Values', (2009) 78 *Fordham Law Rev.* 1143, 1150-51; Owen Fiss, *The Law as it Could Be* (New York University Press, 2001) 53, 57.

35 Owen Fiss, 'Against Settlement' (1984) 93 *Yale Law Journal* 1073, 1075.

36 Jeffrey Stempel, 'Contracting Access to the Courts: Myth or Reality? Boon or Bane?' (1998) 40 *Ariz. L. Rev.* 965, 998; Resnik, 'Many Doors? Closing Doors? Alternative Dispute Resolution and Adjudication' (1995) 10 *Ohio State Journal on Dispute Resolution* 211, 217; Alexander Holtzoff, 'The Elimination of Surprise in Federal Practice' (1954) 7 *Vand. L. Rev.* 576, 577. "The purpose of litigation is not to conduct a contest or to oversee a game of skill, but to do justice as between the parties and to decide controversies on their merits."

37 Owen Fiss, 'The Supreme Court 1978- Term - Foreword: The Terms of Justice' (1979) 93 *Harv. L. Rev.* 1, 29.

38 Refer Ronit Zamir, 'Can Mediation Enable the Empowerment of Disadvantaged Groups? A Narrative Analysis of Consensus-Building in Israel' (2011) 16 *Harvard Negotiation Law Review* 193; Fiss, O.M. 'Against Settlement' (1984) 93 *Yale Law Journal* 1073, cited in David Luban, 'Settlements and the Public Realm' (1995) 83 *Geo Law Journal* 2619.

39 *Brown v Board of Education* 347 U.S. 483 (1954) was a landmark US case which asserted that establishing separate schools for the Blacks and the Whites was unconstitutional.





to what Owen Fiss famously titled “the achievement of ‘peace’ without achieving true ‘justice’”<sup>40</sup> or what Laura Nader deemed “coercive harmony.”<sup>41</sup>

### *1.3 Defiance of public value and the strictures of public reason*

Fiss’ proposition evoked criticism on the grounds that it was pivoted solely on public law litigation involving class actions and the “rights discourse” and failed to make the private/public distinction.<sup>42</sup> However, Luban interpreted his argument in a more generic sense, by extracting the principle from Fiss’ specific public litigation-based examples.

Luban contends Fiss’ propositions are set in the realm of the “public life conception”, which locates human freedom in the public sphere, and not in the “problem-solving conception” which attends to private market transactions. In Luban’s words<sup>43</sup> “the public life conception contrasts ‘reason-as-deliberation’ to ‘reason-as-technical-ability’”. “Deliberation consists in being sage rather than smart, in building consensus around ideals rather than getting the right answer, and in discovering worthy ends in addition to efficient means”.<sup>44</sup> Adjudication is thus an instrument to evolve the wisest answers after a thorough consideration of principles, and not the quickest ones based on efficiency alone. Since ostensibly private disputes also have a public dimension engaging the values realized in laws,<sup>45</sup> in order to give concrete meaning and expression to the values embodied in legal texts such as the Constitution,<sup>46</sup> one needs to settle private disputes in terms of these public values. “When the parties settle, society gets less than what appears, and for a price it does not know it is paying.”<sup>47</sup> Circumventing the courts through settlement essentially denies them the opportunity “to render an interpretation” on a matter that might require a principle to be clarified or established for future social use, even in a private dispute.<sup>48</sup> Private settlements are made on the parties’ own terms, presumably for their own personal gains, that are not illuminating for the public or the law; the situation is aggravated by the terms of confidentiality that the disputants usually enter into. Therefore, adjudication was the sole means by which meanings of public values could be realized, refined and concretized to give a tangible form to our laws, the loss of which amounts to the loss of something intrinsic to humanity.

This contention however has little to do with achieving justice and is consequently not of much relevance in this paper. A slightly different argument, premised on the same “public values” was recently advanced by Fiss. The article seems to be an effort to answer his critics and extend his reasoning to private disputes as well. He redefined his earlier writings on the “achievement of peace without achieving justice” by advocating the

40 Fiss, O.M. ‘Against Settlement’ (1984) 93 Yale Law Journal 1073.

41 Laura Nader, ‘Controlling Processes in the Practice of Law: Hierarchy and Pacification in the Movement to Re-Form Dispute Ideology’ (1993) 9 Ohio St. J. on Disp. Resol. 1, 8-9.

42 David Luban, ‘Settlements and the Public Realm’ (1995) 83 Geo Law Journal 2619, 2632.

43 David Luban, ‘Settlements and the Public Realm’ (1995) 83 Geo Law Journal 2619, 2634.

44 See Anthony T. Kronman, *The Lost Lawyer: Failing Ideals of the Legal Profession* (Belkap Press, 1993), cited in Luban, *ibid*, 2634.

45 David Luban, ‘Settlements and the Public Realm’ (1995) 83 Geo Law Journal 2619, 2634.

46 Owen Fiss, ‘The Social and Political Foundations of Adjudication’, (1982) 6 Law and Human Behavior 121.

47 Fiss, O.M. ‘Against Settlement’ (1984) 93 Yale Law Journal 1073, 1085.

48 *Ibid*.



need to adhere to “the strictures of public reason”<sup>49</sup> in order to render justice. “Only after hearing witnesses, examining the relevant documents, and sorting out the truth of the lawyers’ claims about the facts and law does a judge have a basis to declare what justice requires: to determine whether the law has been violated and if so, what remedy should be imposed.”<sup>50</sup> According to Fiss, following this procedure “freed him from the constraints of interests and personal circumstance and thus deepened and broadened his understanding of the underlying constitutional value and its implications for the case at hand” thereby increasing his access to justice.<sup>51</sup> In fact, a RAND Corporation<sup>52</sup> study reported that perceptions of “judicial fairness” were highest for trials and lowest for judicial settlement conferences, indicating that “process matters to people, and it is the perceived fairness of processes that matters most.”<sup>53</sup>

This argument undoubtedly holds water, but neither litigation nor procedural justice forms the thrust of this article.<sup>54</sup> Although Fiss was convinced that the adherence to this time-tested procedure is what accounts for a finally ‘just’ result, this is evidently not an absolute given, as admitted by Fiss himself.<sup>55</sup> But the non-occurrence of such a result for him was of throwaway consequence, convinced as he was that litigation should be our key to dispute resolution at any cost. Therefore, it is clear that litigation was Fiss’ primary concern and his efforts were geared towards exemplifying it, by whatever means he could find. While the author agrees with Fiss’ contention that the possibility of the litigation process leading to a just result is greater than negotiations, it is reiterated that demonstrating the benefits of litigation is not as significant in this article as exposing the flaws of negotiations.

Fiss, the godfather of the adjudication versus settlement debate opines that anti-ADR arguments advanced on the basis of elements such as self-interest, imbalances of material resources, inequalities of information, and strategic behaviour are unflatteringly clichéd. Although his initial theories on the supremacy of adjudication over negotiations and mediations dealt with these aspects, he later thought that those arguments were “laboured” and the only real issue of consequence in his essays was his exposition on ADR’s “achievement of peace, without achieving justice”. This is perfectly in line with the reasoning that applauding litigation seemed to have been his only concern since these elements are actually of critical importance to show how purely private negotiations which are seemingly just and mutually amicable are quite unjust.

49 Owen Fiss, ‘The History of an Idea’ (2009) 78 Fordham Law Review 1273, 1277.

50 *Ibid*, 1278.

51 Owen Fiss, ‘The History of an Idea’ (2009) 78 Fordham Law Review 1273, 1277.

52 The RAND (“Research and Development”) Corporation is a US non-profit Organization whose declared purpose is to “improve policy and decision-making through research and analysis”.

53 Deborah R. Hensler, ‘Suppose it’s Not True: Challenging Mediation Ideology’ (2002) J. Disp. Resol. 81, 90 - 92.

54 Although the argument advanced in this paper may sound quite like a veneration of Fiss’ argument in favour of litigation, as clarified earlier, this article doesn’t seek to support any particular form of dispute resolution. While Fiss’ argument stresses on the fact that litigation is better because it adheres to the public values of the people, the emphasis in this paper is on the necessity for *justice*. Although in a subsequent paper (Owen Fiss, ‘The History of an Idea’ (2009) 78 Fordham Law Review 1273) he placed more emphasis on justice, his primary concern was still with glorifying litigation. Even then, the thrust of his paper lay in extolling the virtues of the public reason-driven litigation as the *path to justice*. His unashamed admission that he should have expounded on this argument in greater detail in his previous writings makes it seem uncannily like he found that the language of justice was the most effective and convenient means to justify and exemplify his first love – adjudication. The difference in our approaches arises in that the view that the litigation process sometimes not resulting in a just outcome was for him a peripheral concern (obsessed as he was with advocating litigation); for me that is a central concern.

55 Owen Fiss, ‘The History of an Idea’ (2009) 78 Fordham Law Review 1273, 1277.



### 1.4 Distributive and procedural injustice

A summary of the theoretical constructs of justice postulated by various scholars becomes necessary before proceeding. Justice has been categorized into two basic forms- distributive and procedural. Distributive justice weighs the justness of the final outcome of the negotiation i.e it deals with the substantive result of the settlement process. It commonly sets out three choices for the parties: equity, equality generosity and need.<sup>56</sup> While equality is the equal distribution of the benefits of the transaction, equity is the distribution according to the relative contribution of the party to the deal. Generosity decrees that one person's outcome should not be more than that achieved by another, while need divides the benefits so as to assign a greater share to the needier person. Procedural justice, as is evident from the term itself, capitulates the degree of justice inhered in the "process" that leads to the settlement. It has been further classified into structural justice and interactional justice.<sup>57</sup> Structural justice refers to the physical, social and issue constraints that are a "given" in negotiations,<sup>58</sup> such as the balance of power or the relationship between the two parties whereas interactional justice pertains to the quality of treatment meted out to the parties during the negotiation, such as giving them equal opportunities to be heard.

#### 1.4.1 Distributive injustice

Distributive injustice arises from the fact that the parties' mutual choice of a criterion from amongst the four available options of distributive justice is in most cases simply a consequence of situational demands, reflecting nothing more than a selection they feel would satisfy the opposite party enough to reach a successful solution although it is not a just outcome. As a matter of fact, what is perhaps more critical to a negotiation than conjure the best deal for oneself, is to contemplate a deal that is acceptable to the other party.<sup>59</sup> Empirical studies have demonstrated that a party making a "fair" offer is only trying to "appear fair" and offers more simply to avoid rejection and fuel their own self-interest.<sup>60</sup> According to (Schelling, 1960; Young, 1994) fairness notions play a poignant part in evolving a solution that satisfies both parties, for a party is often willing, subconsciously even, to enter into a compromise which they *consider* fair, even if it isn't entirely what "justice" demands.<sup>61</sup>

56 M. Deutsch, 'Equity, Equality, and Need: What Determines Which Value Will Be Used as the Basis of Distributive Justice?' (1975) 31 *Journal of Social Issues* 137, cited in H. Sondak, M. Neale, and R. Pinkley, 'Relationship, Contribution, and Resource Constraints: Determinants of Distributive Justice in Individual Preferences and Negotiated Agreements' (1999) 8 *Group Discussion and Negotiation* 489; Karen A. Hegtvedt and Karen S. Cook, 'Distributive Justice: Recent Theoretical Developments and Applications', in Joseph Sanders & V. Lee Hamilton (eds.), *Handbook of Justice Research in Law* (Plenum Publishers, 2001), 95-96; Kwok Leung and Michael W. Morris, 'Justice Through the Lens of Culture and Ethnicity', in Joseph Sanders and V. Lee Hamilton (eds.), *ibid*, 352.

57 R. Folger and R. Cropanzano, *Organizational Justice and Human Resource Management* (Sage, 1998); Greenberg, J. 'Organizational justice: Yesterday, today and tomorrow' (1990) 16 *Journal of Management* 399; B.P. Niehoff, B.P. and R.H. Moorman, 'Justice as a Mediator of the Relationship between Methods of Monitoring and Organizational Citizenship Behaviour' (1993) 36 *Academy of Management Journal* 527, cited in Mitsuteru Fukuno and Ken-Ichi Ohbuchi, 'Procedural Fairness in Ultimatum Bargaining: Effects of Interactional Fairness and Formal Procedure on Respondents' Reactions to Unequal Offers' (2003) 45 *Japanese Psychological Research* 152.

58 Z.J. Rubin and B. Brown, *The Social Psychology of Bargaining and Negotiation* (Academia, 1975), cited in Cecilia Albin, 'The Role of Fairness in Negotiation' (1993) 9 *Negotiation Journal* 223, 226.

59 William Zartman, *et al.*, 'Negotiation as a Search for Justice' in *International Negotiation* (Martinus Nijhoff Publishers, 1996), 81.

60 Madan M. Pillutla and J. Keith Murnighan, 'Fairness in Bargaining' (2003) 16 (3) *Social Justice Research* 24, 244. The ultimatum game study conducted by Pillutla and Murnighan supports such a finding. When a third party was evaluating the offers, almost all of the offerers increased their offers. Also, when offers had "This is fair" labels attached to them to mislead the respondents, offerers acted exploitatively by significantly reducing their offers, knowing that respondents would accept them anyway. The researchers also noted that Kravitz and Guntto's findings too showed that offerers make very small offers if they knew that respondents would accept all of their offers.

61 A. Falk, E. Fehr and U. Fischbacher, 'On the Nature of Fair Behaviour' (2003) 41(1) *Econ. Inq.* 20. A ultimatum game study conducted by Falk



Which fairness criterion is ultimately relied on by the parties rests primarily on external factors, the likes of which include self-interest, social relationships, and the interaction between cultural norms and situational needs.<sup>62</sup> For instance, a situation where the parties have an existing relationship that they wish to maintain would certainly evoke a much fairer outcome than one where the parties are looking simply to get the best economic outcome for themselves out of the deal.<sup>63</sup>

The above proposition that fairness criteria are simply based on attempting to satisfy the other part is illustrated by the common tendency to opt for the supposedly just principles of equality or splitting-the-difference (which means reaching a mid-point between the parties' initial demands), since this demands equal concessions from both sides.<sup>64</sup> In most cases involving these principles however, "the prominence of a particular fairness notion comes less from any innate moral force, and more from its known appeal and power to coordinate expectations, forge agreement in ambiguous situations of multiple alternatives, and legitimize the outcome before important constituencies".<sup>65</sup> Therefore, it is not necessarily the impartial procedure it is so often portrayed to be, and is only used as a tool to mislead the other party. The exchange of equal concessions will lead to a fair (equal-split) outcome only when parties' initial positions are equally far from their respective security points.<sup>66</sup>

Despite the prominence of equality, unequal concessions or mismatching is as much a necessity and commonality in negotiation as equality. Parties are forced to bend to unfavourable solutions in a plethora of cases, simply because they value reaching a settlement more than adhering to fairness, whether due to an emergency or due to a need. Reciprocity, i.e. "mutual responsiveness to each other's concessions", the norm that measures fairness in negotiations and doesn't always require repayment be equal in value to be fair.<sup>67</sup>

A real-life illustration of a negotiation encompassing conflicting aspects of "justice" was the 1987 Montreal Protocol on Substances That Deplete the Ozone Layer. While the developing countries unsurprisingly relied on the "need" principle, wherein the burden of the destruction was sought to be transferred from the "needy" developing nations to the developed ones, the developed countries favoured the "equity" principle, arguing that each country's liability ought to be proportional to their emission levels.<sup>68</sup>

*et al.*, determined that respondents would reject offers if the offerers could offer more but didn't. They however accepted the same offer when the offerer had the choice to offer nothing at all. These data indicate that people base their behaviours on their personal conclusions about fairness, rather than on an objective standard.

62 Nancy A. Welsh, 'Perceptions of Fairness in Negotiations' (2004) 87 Marquette Law Review 753, 754.

63 Max H. Bazerman and Margaret A. Neale, 'The Role of Fairness Considerations and Relationships in a Judgmental Perspective of Negotiation', in Kenneth Arrow *et al.* (eds.), *Barriers to Conflict Resolution* (W.W. Norton and Co., 1995), 98-100.

64 Benton, A. and Druckman, D. 'Salient Solutions and the Bargaining Behaviour of Representatives and Non-representatives' (1973) 3 International Journal of Group Tensions 28, cited in Cecilia Albin, 'The Role of Fairness in Negotiation' (1993) 9 Negotiation Journal 223, 230. Especially if it is the case of a distributive negotiation, experimental findings suggest splitting-the-difference, is a commonly accepted notion of outcome fairness.

65 Schelling, T.C. *The Strategy of Conflict* (Harvard University Press, 1960), cited in Cecilia Albin, 'The Role of Fairness in Negotiation' (1993) 9 Negotiation Journal 223, 231; Zartman, 'Negotiation as a Search for Justice' in *International Negotiation* (Martinus Nijhoff Publishers, 1996), 87. Zartman *et al* note that equality and its variants are the most popular solutions in negotiation because of its utility as a "fair" meeting point between the parties divergent interests. Studies by Siegel and Fouraker, Joseph and Wills, Benton and Druckman, and Lamm and Rosch have proved that equality as a principle produces results much faster and much more easily than if other fairness principles are used.

66 Cecilia Albin, 'The Role of Fairness in Negotiation' (1993) 9 Negotiation Journal 223, 235. Reciprocal concessions are not always the fairest solutions since equal concessions are fair only if the initial positions of the two negotiators are reasonably on the same level. Simply backing down to an equal measure from the starting point is presumed to be fair since none usually question the initial security points of the parties to see if they are in themselves fair. This predicates unfairness in negotiation solutions.

67 Zartman, 'Negotiation as a Search for Justice' in *International Negotiation* (Martinus Nijhoff Publishers, 1996), 82.

68 Cecilia Albin, 'The Role of Fairness in Negotiation' (1993) 9 Negotiation Journal 223.



Ultimately, fairness is simply an element of acceptability, the means to an end. The key is to strike a “fair balance” between the two objectives of the parties when they are conflicting, and not search for objective “justice” *per se*. As Zartman *et al* put it, “Negotiating parties need to reconcile their differing notions and arrive at a common sense of justice, one that is both favourable to each and applicable to both.”<sup>69</sup> This sentence sums up the sense with which justice is regarded in negotiations and mediations, merely accounting for the parties personal perceptions of fairness and almost completely unconcerned whether justice was truly met or not.

### ***1.4.2 Procedural injustice***

Procedural (in)justice is a core determinant of the justness of the eventual result for they have a profound impact on the outcome of the negotiations. The article will examine procedural justice from the lens of both a) the structural procedural justice and b) the interactional procedural justice.<sup>70</sup>

#### **a. Structural procedural justice**

The structural components of a negotiation are the most colloquial criteria used for an appraisal of the justness of the process. Structural elements are those “givens” in a negotiation or mediation which remain relatively unchanged throughout the proceedings and influence the outcome subtly but substantially, such as the financial imbalance between the parties and the disproportionate negotiation expertise of the parties.

No anti-negotiation theorist has ever neglected to lay acute emphasis on the perennial problem of financial inequality between the bargaining parties. The monetary prowess of a party in comparison to the other invariably leads to the tipping of the scales in their favour. The injustice, according to Fiss stems from three basic determinants:

- i) The poorer part is unable to amass information to predict the outcome of the bargaining process,
- ii) His desperation and urgency for money may act as an inducement leading him to accept even an unfair settlement, or
- iii) He may be forced to settle due to his inability to finance the litigation process.<sup>71</sup>

While ADR proponents may decry this ‘prevalence-of-the-affluent-over-the-destitute’ argument by declaring that they form an irresolvable part of litigation as well, it is well worth noting Fiss’ counter-argument that “there is a critical difference between a process like settlement which is based on bargaining and accepts inequalities of wealth as an integral and legitimate component of the process and a process like judgment,

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<sup>69</sup> Zartman, ‘Negotiation as a Search for Justice’ in *International Negotiation* (Martinus Nijhoff Publishers, 1996), 87.

<sup>70</sup> Although I am primarily targeting the substantive results of the negotiation for the purposes of this study, analyzing the two procedural forms of justice becomes necessary as the dependency relation between the outcome and the procedure functions as one of the biggest contributors to the lack of objective justice in negotiations.

<sup>71</sup> Fiss, O.M. ‘Against Settlement’ (1984) 93 Yale Law Journal 1073, 1076.





which knowingly struggles against those inequalities.”<sup>72</sup> Although litigation may not be able to erase this hiatus between the parties, the intercession of a neutral adjudicator numbs the impact of the inequality to a great extent.

This enduring problem aside, Astor outlines a power imbalance situation where women who are “traditionally disempowered or...oppressed by a particular relationship, (may) negotiate for what they think they can get, rather than what is...equitable.”<sup>73</sup> Such women naturally carry with them their past experiences which pressures them during the negotiation even if there is no coercion at the negotiation table itself. He found that mediations that took place in such a tense climate rarely produced just or equitable results.

Consider another bargaining situation between an employer and an employee. The employer will naturally have greater power than the employee since he can afford to let the employee go. The employee, who is aware of the alternative that the employer has, may settle for a lower increase in salary than he deserves, gratified that the powerful party even deigned to consider his views and demands important.<sup>74</sup> This phenomenon is consistent with empirically proved theories which observe that in a negotiation between unequals, the people who perceive they are of a lower status are satisfied with an unfavourable outcome that exceeds their subjective expectations as long as interactional justice was adhered to by the other party.<sup>75</sup>

Then there is inequality occasioned by information disparity in situations which involve “repeat players”, which are more in number than one can believe possible. The “repeat player” concept was espoused by Professor Galanter in his seminal 1974 essay *‘Why the “Haves” Come Out Ahead’*. It refers to negotiators who engage in negotiations repeatedly and frequently, such as employers and governments, thereby gaining “a richer and more nuanced grasp of relevant precedents than occasional or ‘one shot’ participants,” which gives them an upper hand over the negotiation than the one-shot participant.<sup>76</sup> Instead of emerging as an alternative to the “courthouse”, negotiations seem to have “created a segmented and hierarchical system skewed dramatically toward business litigants and a few other players. It is a milieu in which only a few constituencies are comfortable making their arguments and confident that their concerns will be understood.”<sup>77</sup>

These are just a few examples to illustrate the point the author wishes to make. The essence of the argument is that in most negotiations the result may prima facie seem ‘just’ or ‘fair to both parties’ since there has been

<sup>72</sup> *Ibid.*

<sup>73</sup> H. Astor, ‘Violation and Family Mediation Policy’ (1994) 8 Australian Journal of Family Law 3, 5, cited in Manning, C. “Power Imbalance in Mediation” <<http://www.carolynmanningconsultingservices.com.au/Power%20Imbalance%20in%20Mediation.pdf>> (accessed 2 June 2012)

<sup>74</sup> Welsh, ‘Perceptions of Fairness’, in A. K. Schneider and C. Honeyman (eds.), *The Negotiators’ Fieldbook* (1st ed., American Bar Association, 2006), 171.

<sup>75</sup> Guthrie, C. and Levin, J. ‘A Part Satisfaction Perspective on a Comprehensive Mediation Statute’ (1998) 13 Ohio State Journal on Dispute Resolution 885; Ya-Ru Chen *et al.*, ‘When is it a ‘Pleasure to do Business With you?’ The Effects of Relative Status, Outcome Favourability and Procedural Fairness’ cited in Welsh, *ibid.*

<sup>76</sup> Galanter & Cahill, ‘Most Cases Settle’: Judicial Promotion and Regulation of Settlements’, (1994) 46 Stanford Law Review 1339, 1353, cited in Don Ellinghausen, Jr. ‘Justice trumps Peace: The Enduring Relevance of Owen Fiss’ *Against Settlement*’.

<sup>77</sup> Bryant G. Garthy, ‘Tilting the Justice System: From ADR as Idealistic Movement to a Segmented Market in Dispute Resolution’ 18 Ga. St. U. L. Rev. 927; Carrie Menkel-Meadow, ‘Do the “Haves” Come Out Ahead in Alternative Judicial Systems?: Repeat Players in ADR’ (1999) 15 Ohio. St. J. on Disp. Resol. 19, 25-26. Carrie Menkel-Meadow seconds this assertion, noting that such repeat players avoid the risks inherent in public litigation by “choosing more streamlined and controlled forms of private justice,” not just for disagreements with each other but “now when they impose mandatory private dispute resolution schemes on their employees, clients, customers, patients, franchisees, and licensees.”



no overt show of power or perceived interactional injustice, but the inherent structural inadequacies which are always present and usually overlooked makes us wonder whether they were indeed just outcomes.<sup>78</sup> Only a third-party viewpoint would consciously highlight these concerns and demonstrate the injustice implicit in the proceedings.

b. Interactional procedural injustice

Interactional justice concerns provide another field of study for such objectively unjust compromises. More often than not, mere adherence to interactional justice causes the other party to regard the justness of the final outcome with lesser attentiveness than it deserves. "Participant perceptions of procedural fairness are crucial to the participant's acceptance of the decisional outcome as substantially fair."<sup>79</sup> If people believe they have been fairly treated during the course of the negotiation (and they have indeed been treated as such), such as being given a fair opportunity to voice their views, they generally tend to believe that the resultant outcome is fair as well. The high degree of co-relation between the two forms of justice has been empirically proved.<sup>80</sup> The fairness of the final outcome, even from the party's own viewpoint becomes all the more suspect in such a case, since the party does not even satisfactorily assess the outcome; objective justice is but a far cry.<sup>81</sup>

Worse still is a situation where even the interactional justice is only a myth. Instances where a mere 'show of fairness' as a conciliatory gesture by party 'A' leads the opposite party 'B' to believe that his views have found a place in the negotiation are in plenty. While he may indeed have been given an equal chance at making his point, the sympathetic ear lent to him need not necessarily have registered his point, or may have even discarded it carelessly after hearing it.

While the preceding situation of ignoring party 'B's' perspective evinces a passive move on the part of party 'A', interactional injustice also manifests itself in the employment of a more active but subtle means of unfairness. As shall be demonstrated below, the problem arises in that there may not be an overt deception

78 Fiss, O.M. 'Against Settlement' (1984) 93 Yale Law Journal 1073. Fiss opines that this is because bargaining processes accept inequalities of wealth as an integral and legitimate part of the process, unlike adjudications which make a conscious effort to stamp out these inequalities.

79 Richard C. Reuben, 'Democracy and Dispute Resolution: the Problem of Arbitration' (2004) 67 Law and Contemp. Probs. 279, 294.

80 Deutsch, M. 'Justice and Conflict', in Deutsch, M. and Coleman, P.T. (eds.), *The Handbook of Conflict Resolution: Theory and Practice* (Jossey-Bass, 2000), 45; T. Nabatchi and L. Bingham 'Expanding our Models of Resolution in Dispute Resolution: A Field Test of the Contribution of Interactional Justice', (paper presented at the International Association for Conflict Management); Lind, E.A. 'Procedural Justice, Disputing and Reactions to Legal Authorities', in Sarat, A. *et al* (eds.), *Everyday Practices and Trouble Cases* (Northwestern University Press, 1998), 177, 185; Lind, E.A. *et al*, 'Voice, Control and Procedural Justice: Instrumental and Non-Instrumental Concerns in Fairness Judgements' (1990) 59 Journal of Personality and Social Psychology 952, 957; Lind, E.A., Kulik, C.T., Ambrose, M. and de Vera Park, M.V. 'Individual and Corporate Dispute Resolution: Using Procedural Fairness as a Decision Heuristic' (1993) 38 Administrative Science Quarterly 224; Tyler, T. 'Psychological Models of the Justice Motive: Antecedents of Distributive and Procedural Justice' (1994) 67 Journal of Personality and Social Psychology 850, 852, cited in Welsh, 'Perceptions of Fairness', in A. K. Schneider and C. Honeyman (eds.), *The Negotiators' Fieldbook* (1st ed., American Bar Association, 2006), 170; Richard C. Reuben, 'Democracy and Dispute Resolution: the Problem of Arbitration', (2004) 67 Law and Contemporary Problems 279, 294.

81 Admittedly, the same argument may arise for litigations as well, where the procedural justice is given undue weightage under the assumption that the substantive result will necessarily be fair. However, the false effect of such a belief in the litigation sphere is mitigated by the fact that it is objective standards that determine the result and that it is a neutral third-party which is rendering the decision after considering even decisional outcome justice, unlike negotiations where the parties are interested parties or meditations where the mediators do not interfere in the outcome. Although the result, even in litigations, depends on the subjective choice of the judge, at the very least, it is objective with respect to the parties and therefore, there is a greater faith in the 'justness' of the decision rendered. That is precisely the reason why even a judge party is not allowed to adjudicate on a dispute if he is an interested.



or unfairness in the procedure as such, but implicit manipulative tactics that on the face of it 'seem' fair, but might not be so considered when judged on a yardstick of objective fairness. It stems from the fact that people are conditioned to believe that such deceptions are a regularity in negotiations.<sup>82</sup>

I shall illustrate my proposition with an incident that Cohen narrates in his book 'You Can Negotiate Anything',<sup>83</sup> detailing a situation where he went to buy a VCR. He says that he first built a relationship with the owner by indulging in small talk with the shopkeeper for 25 minutes, pretending to be interested in several other objects in the store. He casually selected the VCR without showing any undue preference and when the shop owner started to write out a receipt Cohen kept deliberately and repeatedly emphasizing that he would be relying on the honesty of the owner. He occasionally threw in snide comments such as "I don't know what these things cost. In fact, I haven't the faintest idea. I'll trust you when it comes to a fair price" and "I want you to make a reasonable profit, John . . . but, of course, I want to get a reasonable deal myself". He even added a hint that he might be willing to make future purchases from the shop but qualified it with a "John, if I should find out that my trust was misplaced, this disappointment will prevent me from giving you any additional business". Throughout the conversation the shopkeeper remained bent over the bill, but each time Cohen uttered something to this effect he noticed the shopkeeper cutting out and revising the numbers.

Although there was no overt unfair means used by Cohen there was a whiff of deception in it. Ultimately Cohen managed to extract a great deal, including a discount, a stand that he hadn't even asked for and the installation of the VCR which wasn't included in its sale, by appealing to the objective fairness of the shop owner and using norms of trust and fairness as a psychological leverage. Ethical norms are often invoked as such, as simply rhetorical tools to serve your own self-interest. Cohen describes this tactic as "laying morality on people in an unqualified way" which "often works".<sup>84</sup> Neither party felt that the deal was unfair, since the owner had volitionally agreed to the deal, but assessing it as a third party, it may well be that the shop owner had been unjustly, albeit cleverly deceived by Cohen. Although this is just an example of an informal negotiation, it serves to illustrate the point that an 'over-reliance on fairness standards' by one of the parties (the shop owner in this case was tactfully manipulated to consider fairness in manner which caused him to think more fairly than necessary) might actually lead to an unjust result.

One other real-life negotiation shows how an inviolable legal argument caused an unjust procedure to acquire the status of being 'fair' and be so accepted. Ronit Zamir (2011) has analyzed a situation in the context of a consensus- building public environmental dispute in Israel. The conflict was between the minorities residing in the Nahal Talzmon region and the State which wanted to turn the region into a national park. What transpired in the name of an impartial negotiation was actually the fortification of hegemonic structures in society. During the interaction and joint fact-finding, the subverted group was precluded from bringing to the

<sup>82</sup> Carrie Menkel-Meadow and Michael Wheeler (eds.), *What's Fair: Ethics for Negotiators* (1st ed., Jossey-Bass, 2004), XXIII. For instance, Rule 4.1 of the American Bar Association's Rules of Professional Conduct prevents a lawyer from withholding a material fact or making a false statement. However some of these standards are relaxed when it comes to negotiations and attempts to toughen them up in 1983 and 2000 have failed as well, in light of "formal recognition of a professional culture that deals with regularity in expected deception."

<sup>83</sup> Cohen, H. *You Can Negotiate Anything* (Bantam Books, 1982), cited in Michael Wheeler, 'Swimming With Saints/Praying with Sharks', in Carrie Menkel-Meadow and Michael Wheeler (eds.), *What's Fair: Ethics for Negotiators* (1st ed., Jossey-Bass, 2004), XXXIX.

<sup>84</sup> *Ibid.*



table their history of subversion. The houses built by the residents were, according to the law, illegal since it was not a part of the Outline Plan. The existing law however, was framed in such a clandestine manner that it failed also to provide for a procedure to allow the residents to obtain a license. This contention, housed in the alternative legal discourse of historical justice and of conscience, the residents tried to advocate was nipped in the bud by the Government as well as the mediator, who tactfully washed his hands off the matter by referring the issue to a legal expert. He well knew that the expert would impress the so-called neutral law on the residents, who would then be willing to accept it. After all, it seemed only fair, since the law was being religiously followed. The defence of the neutral law therefore gave the status of truth to a partial theory, which led to the reinforcement of the hegemonic theory. Under the guise of fairness, the mediator allowed for injustice and from an objective perspective, this may seem utterly unfair. Admittedly the final settlement was not unjust, but this might have been due to the Government's necessity to keep the people happy so that they wouldn't impede the building of the park. It cannot be denied that the result may well have gone against the residents if not for this selfish concern of the Government.<sup>85</sup>

This argument as regards interactional injustice has been aptly captured by Lax and Sebenius (especially with respect to commercial agreements for which it is hardest to justify the need for objective justice):<sup>86</sup>

If 'shrewd' moves allow a large firm to squeeze a small merchant unmercifully or an experienced negotiator to walk away with all the profit in dealings with a novice, something may seem wrong. Even when the nature of the tactics is not in question, the "fairness" of the outcome may be.

Most of the examples set out above show how a supposedly fair result was actually unjust because of the subtle unfairness implicit in the procedural aspects, something the parties failed to identify.

### ***1.5 Self-interest motivated outcomes***

After examining the situations outlined above, it cannot be denied that parties rely on fairness considerations to reach satisfactory settlements in a negotiation or mediation, sometimes without conscious thought. Truth be told, solutions would hardly materialize if it was considered unfair by even one of the parties, and understandably so, since no party would willingly accept a solution they consider is not fair to them; there is

evidence that getting a fair deal is often considered more important than getting the best deal.<sup>87</sup> These "fair"

<sup>85</sup> Ronit Zamir, 'Can Mediation Enable the Empowerment of Disadvantaged Groups? A Narrative Analysis of Consensus-Building in Israel' (2011) 16 Harvard Negotiation Law Review 193. While it is possible that the same injustice would have even taken place in a litigation process, the author defends this by saying it was probably the very fact that the parties were non-legal persons that made them rely on the law so much. The law acknowledges that there cannot be just one single solution to any problem. Besides, "justice and good conscience" principles implicit in the law might have allowed the court to override this legal point; See also Boulle, L. *Mediation: Principles, Process and Practice* (Butterworth, 1996), 56. Burton (cited in Boulle 1996) argues that mediation provides "private justice behind closed doors... encouraging the exploitation of the powerless". One might also argue that the same result would have occurred even in a court of law. But the author counters this argument by saying it was probably the awe of law that non-legal people have which resulted in such a stand being taken in the negotiation. Had the same dispute taken place in a court of law, there was greater chance that the court would have, at the very least, allowed the residents to advance their argument in a spirit of justice and good conscience. Besides, the neutrality and impartiality of the law which treats every person equally, would have ironed out the power imbalance to a greater extent.

<sup>86</sup> Lax, D.A and Sebenius, J.K 'Three Ethical Issues in Negotiation', in Carrie Menkel-Meadow and Michael Wheeler (eds.), *What's Fair: Ethics for Negotiators* (1st ed., Jossey-Bass, 2004), 10.

<sup>87</sup> E. Allan Lind and Tom R. Tyler, *The Social Psychology of Procedural Justice* (Plenum Press, New York, 1988) cited in William Zartman, *et al.*,



consensus-based outcomes reached in negotiations and mediations have traditionally been hailed as “just” outcomes, based on the reasoning that both the parties have by their own volition worked out a mutually satisfactory solution.<sup>88</sup> In fact, it has been argued that this is more desirable and more just than judgments dished out by judges, which it is said would invariably be unacceptable for the one party which would be put to a complete loss since litigations rely on a win/lose result.

But that right there is the problem the author seeks to identify, that “justice” in negotiations depends solely on the parties’ personal choice of the type of justice,<sup>89</sup> according to the nature of the dispute and their ideas and interests. Fairness elements are typically used by the parties as a tool to bolster and legitimize the position which favours their interests. Even if “real fairness” is sought for, it is simply to prevent constant confrontation and stalemates owing to the parties’ BATNA. Eventually the parties may end up choosing what in their eyes is fair, splitting the difference between their fairness principles or one of them compromising fairness and concluding the agreement on non-fairness principles.<sup>90</sup>

It is quite clear then that “justice” – whether distributive or procedural – is largely a matter of perception.<sup>91</sup> Perceived “justice” is different from actual justice. The ancient and more recent philosophers identified a number of elements that can contribute to a definition of justice, including (i) deservingness (the early Romans and Aristotle), (ii) generally rather than individually applicable acts, i.e., people’s actions are not only relevant for themselves (Kant and Mill), (iii) intentionality (Aristotle, Kant, and Mill), (iv) not self-interested (Kant and Hume) and (v) not charity (Mill), none of which are met by negotiations and mediations.<sup>92</sup> Therefore, whether there is anything inherently ‘just’ about the notions of ‘fairness’ that the parties rely upon is evidently questionable.<sup>93</sup>

Pillutla and Murnighan’s comprehensive review of research studies concluded that what one terms as fair solutions can generally be conceived as motivated by self-interest.<sup>94</sup> One such negotiation simulation verified that people had different notions of fairness when asked to view a particular situation as a third party judge, and when roles were reversed to make them one of the parties. The subjects of the simulation were intimated with a particular fact situation where a motorcyclist met with an accident when he hit a car which resulted in him being injured. They first determined as a neutral third party the damages that the motorcyclist was fairly entitled to. Subsequently they were assigned roles as one party or the other and it was found that most negotiations were concluded with ease. Another set of people were then assigned the roles first, and discovered the fact situation while the negotiation was in progress. They had a much harder time in effecting a settlement.

<sup>88</sup> ‘Negotiation as a Search for Justice’ in *International Negotiation* (Martinus Nijhoff Publishers, 1996), 80.

<sup>89</sup> William Zartman, *ibid*, 79.

<sup>90</sup> The types of justice are detailed in the section on “Distributive and Procedural Injustice”.

<sup>91</sup> Cecilia Albin, ‘The Role of Fairness in Negotiation’ (1993) 9 *Negotiation Journal* 223, 231.

<sup>92</sup> Nancy A. Welsh, ‘Perceptions of Fairness in Negotiations’ (2004) 87 *Marquette Law Review* 753, 776.

<sup>93</sup> Madan M. Pillutla and J. Keith Murnighan, ‘Fairness in Bargaining’ (2003) 16 (3) *Social Justice Research* 24, 244.

<sup>94</sup> T.C. Schelling, *The Strategy of Conflict* (Harvard University Press, 1960) cited in Cecilia Albin, ‘The Role of Fairness in Negotiation’ (1993) 9 *Negotiation Journal* 223, 231.

<sup>95</sup> Madan M. Pillutla and J. Keith Murnighan, ‘Being Fair versus Appearing Fair: Strategic Behaviour in Ultimatum Bargaining’ (1995) 38 *Acad. Manage. J.* 1408; Madan M. Pillutla and J. Keith Murnighan ‘Fairness versus Self-Interest: Asymmetric Moral Imperatives in Ultimatum Bargaining’ in R. M. Kramer, and D. M. Messick (eds.), *Negotiation as a Social Process* (Sage Publications, 1995); Madan M. Pillutla and J. Keith Murnighan, ‘Fairness in Bargaining’ (2003) 16 (3) *Social Justice Research* 24, 244.





The simulation successfully demonstrated how the pre-negotiation fairness outcome that was contemplated by a subject as a neutral party in the first case was tainted by self-interest in the second, making it harder to reach a conclusion.<sup>95</sup>

The singular question is “Can an outcome motivated by self-interest ever be called just, regardless of the parties’ acquiescence?” Most theories of justice, such as the famous Rawlsian theory, are fundamentally premised on the hypothetical assumption of the neutrality of the deciding party; that to achieve justice, human beings have to be in a state where they are unaware about their own standing and interests in the society.<sup>96</sup> Even practically, the fact that we always stress on impartial uninterested parties to resolve disputes, such as judges and mediators and independent ‘arbitrators’, furthers this view.<sup>97</sup> Consequently, the author’s assertion that justice has never occupied a substantial part of the discussions or literature on ADR is justified. It has always been unquestionably presumed, without any deliberate assessment, that the outcome is just since both the parties have acquiesced in it, no regard being attributed to a third-party’s consideration of its justness.

## **II. The need to actualize justice is necessary to prevent the Promotion of a ‘culture of injustice’**

Injustice anywhere is a threat to justice everywhere. We are caught in an inescapable network of mutuality, tied in a single garment of destiny. Whatever affects one affects all indirectly.

- Dr. Martin Luther King, Jr.

The language of ‘access to justice’ is instinctively associated with the public law dimensions of social inequalities and structural imbalances in disputes.<sup>98</sup> Class actions, minority reservations, gay rights and mass torts are the type of issues that spring into one’s mind. This is perhaps the sole reason why justice concerns have remained non-functional in negotiations and mediations which for the most part deal with transactions like commercial and business matters and community and familial disputes. But the fact of the matter is that justice is equally applicable to every private transaction as well. It is not the incidence of social issues being involved in the dispute that ought to dictate the necessity for justice. Justice is a transcendent ideal, something so fundamentally and intrinsically necessary that one cannot superficially characterize it according to the type of dispute.

Understandably, neither negotiation nor mediation is encouraged in the field of criminal law. Criminals are considered vices of the society, and their actions are universally understood to “affect the society at large”. This reasoning underlines the mandate of law requiring the State to prosecute the offender, even in cases where only a single person has suffered the actual harm. Settling the matter at a personal level is disallowed in most cases even by the law itself, as can be inferred from instances like plea bargaining where a criminal can be forgiven by the victim or any other legally authorized representative only with the intervention and permission

<sup>95</sup> Leigh Thompson & Janice Nadler, *Judgmental Biases in Conflict Resolution and How to Overcome Them* in Morton Deutsch and Peter Coleman (eds.), *Handbook of Conflict Resolution* (Jossey-Bass Publishers, 2000), 225.

<sup>96</sup> S. Freeman, ‘Original Position’, Edward N. Zalta (ed.), *The Stanford Encyclopedia of Philosophy* (Spring 2009 Edition) (27 February 1996) <<http://plato.stanford.edu/entries/original-position/>> (accessed on 3 June 2012)

<sup>97</sup> Owen Fiss, ‘The History of an Idea’ (2009) 78 Fordham Law Review 1273, 1277, 1279.

<sup>98</sup> David Luban, ‘Settlements and the Public Realm’ (1995) 83 Geo Law Journal 2619, 2621.



of the Court. The reasons behind such a law are not that hard to fathom. Forgiving a person who has wronged the society would erode justice, and negatively affect the interests of the society, not just by turning loose that one offender but also by encouraging such crimes. One such case can therefore influence and determine the attitude of several people in future. What legions of negotiation enthusiasts have perhaps overlooked is that the same effects invariably arise in settlements concerning petty criminal cases and even civil cases, albeit more subtly and on a smaller scale.<sup>99</sup>

Can a single person vouch for a contention that the aspiration for 'justice' when we proceed for litigation is confined to criminal or public matters alone? That we do not expect justice when we approach the Court for private civil disputes? Despite the usual inflexibility of laws and the strict interpretation accorded to them, even formal laws and litigation processes accommodate justice concerns by way of broadly sweeping concepts like 'in the interests of justice and good conscience'. Courts are referred to as 'Courts of Justice' and judges are expected to provide 'justice', not 'solutions', to the litigants. There is a reason why even private disputes are resolved in a public sphere, why they are resolved in accordance with publicly evolved consensus norms,<sup>100</sup> why objective standards are set for such a resolution and why justice runs like a fine golden thread throughout this framework. Negotiations, as private bargains, set their own rules and standards, typically those of efficiency and self-interest, in stark contrast to the standards of impartiality and justice set in adjudications which happen in the public sphere. The crux of the whole issue is not just that negotiations fail to produce a just outcome, but that these outcomes are considered legitimate and acceptable even by the parties themselves, notwithstanding the fact that they are aware about the injustice implicit in them. The tactics and structural deficiencies are consciously given free rein, since people assume that subtle unfair elements in bargaining settlements are unavoidable and in fact, it is justified for the parties to make use of the advantages they possess.

However, it needs to be borne in mind that although the main aim of each negotiation is to resolve the dispute, the manner in which negotiations are conducted and the results itself will be reflective also of the ethical standards adhered to in negotiations. The procedure and substantive result will influence not just the negotiation pattern of the other party but also future negotiations.<sup>101</sup> Thus, each of these negotiations gradually coalesces into a 'negotiation culture' in the society. Given the rapidly increasing number of negotiations, they have the potential to collectively, in the form of a culture, impact the broader societal perceptions of justice. One can imagine what negotiations (such as security fraud settlements) between parties which are motivated by self-interest, are secretly arrived at, and protected with confidentiality agreements, do to civil law enforcement

<sup>99</sup> Owen Fiss, 'Against Settlement' (1984) 93 Yale Law Journal 1073, 1075. Although the backlog of cases in the Courts of Justice may be cut back by the use of such alternative practices, Fiss opines that settlements, like plea bargaining "is a capitulation to the conditions of mass society and should neither be encouraged nor praised".

<sup>100</sup> Although in this section a reference is made to the need for a proper procedure, the process that is referred to is the employment of an impartial judge, and not to the civil or the criminal legal procedures. The only thing this article concentrates on is the inclination *against* a self-interest-induced process (resolved by the use of a non-interested third party), which doesn't include an inclination *towards* any particular process.

<sup>101</sup> Carrie Menkel-Meadow and Michael Wheeler (eds.), *What's Fair: Ethics for Negotiators* (1st ed., Jossey-Bass, 2004), 11. "There is another, more subtle, external effect of the way in which ethical questions in bargaining are resolved. It involves the spillover of the way one person bargains into the pattern of dealings of others. Over time, each of us comes to hold assumptions about what is likely and appropriate in bargaining interactions. Each tactical choice shapes these expectations and reverberates throughout the circles we inhabit"; Susskind, L. 'Expanding the Ethical Obligations of the Mediator: Mediator Accountability to Parties not at the Table', in Carrie Menkel-Meadow and Michael Wheeler (eds.), *What's Fair: Ethics for Negotiators* (1st ed., Jossey-Bass, 2004), 515. "And, while one of the supposed advantages of mediation (over adjudication) is that the special circumstances in each situation can be addressed de novo, it is wrong to presume that the outcome of one mediation (whether formally recorded or not) has no impact on subsequent efforts to resolve similar disputes.... mediated agreements set informal precedents."



and knowledge of human wrongs and corrected remedies.<sup>102</sup> Adopting a hands-off approach and advocating 'privatization of justice' by arguing that no one else need be concerned about the negotiation, will lead to "bargaining ethics becoming a world onto itself, close not just from public view but from public concern and criticism".<sup>103</sup> This will in turn induce parties to care less about fairness and more about self-aggrandizement, so that inequalities and injustice concerns get accentuated, justice gets gradually eroded and eventually a 'culture of injustice' is perpetuated.

This argument can aptly be applied to justify the need for justice in commercial transactions, crucial because there is an intuitive tendency to privatize them and is one of the constant counter-arguments by pro-negotiators. When parties choose to negotiate instead of litigate in commercial matters, one of the main reasons for this is because they do not know exactly who will be favoured in the litigation. It is reasonable to assume that any compromise will inevitably result in the would-be winner conceding something which he otherwise would not have had to in the litigation. Research on bounded rationality in settlements has proved that people do not make an effort to search for the most optimal solution, but settle for a suboptimal solution in most cases, one that is acceptable in terms of effectiveness or performance.<sup>104</sup> The result would unjustifiably enrich the wrong-doer, which is exactly how injustice is occasioned. Although it is commonly argued that negotiations in such commercial matters give you the chance to derive mutual benefit through integrative negotiation, which actually seems quite just,<sup>105</sup> this is actually what may at the most be termed as achievement of peace through maximization of private interests<sup>106</sup> where "cultural notions of justice are factored out".<sup>107</sup> A "decision about fault and liability is often critical to future community peace, psychologically important to individuals, therapeutic for society at large, and a useful way to establish societal norms."<sup>108</sup> Instead, settlements are "often accompanied by exculpatory statements to the effect that no wrongdoing or liability is admitted" and instead emphasis is placed on the fragile rhetoric of "compromise and relationship".<sup>109</sup> Therefore, the parties use the fragile rhetoric of 'relationship maintenance' to There is a great potential for 'repeat players'<sup>110</sup> to misuse this entrenched prejudice of 'relationship' to gloss over their wrongs each time by inducing other parties to negotiate. What they are actually doing is maximizing private gains, at the cost of justice. This trend contributes significantly to the promotion of the 'culture of injustice', which can dangerously penetrate into non-commercial matters as well. Besides, according to Fiss, private settlements do not even promise "true reconciliation", despite its tall claims of maintaining relations. The very fact that the dispute has disintegrated

102 Derek Bok, *Lying: Moral Choice in Public and Private Life* (Pantheon, 1978), cited in Carrie Menkel-Meadow and Michael Wheeler (eds.), *What's Fair: Ethics for Negotiators* (1st ed, Jossey-Bass, 2004) XVII.

103 Elanor Holmes Norton, 'Bargaining and the Ethics of Process', in *ibid.* 291. This reinforces Fiss' contention that "dispute resolution privatizes values," creating an environment in which "there are no public values or goals, only the private desires of individuals." (Owen Fiss, *The Law as it Could Be* (New York University Press, 2001), 52)

104 M. H. Bazerman, *Judgment in Managerial Decision Making* (Wiley Press, New York, 2002), cited in David Cremer and Eric Djik, 'Fairness and Ethics in Social Decision Making' (2003) 16(3) Social Justice Research 191.

105 Michael Mottiff, 'Three Things to be Against (Settlement not included)' (2009) Fordham Law Review 1; William Zartman, *et al.*, 'Negotiation as a Search for Justice' in *International Negotiation* (Martinus Nijhoff Publishers, 1996), 81.

106 Fiss, O.M. 'Against Settlement' (1984) 93 Yale Law Journal 1073, 1085.

107 M. H. Bazerman, *Judgment in Managerial Decision Making* (Wiley Press, New York, 2002), cited in David Cremer and Eric Djik, 'Fairness and Ethics in Social Decision Making' (2003) 16(3) Social Justice Research 191.

108 Steven H. Goldberg, "Wait a Minute, This Is Where I Came In": A Trial Lawyer's Search for Alternative Dispute Resolution, 1997 B.Y.U. L. Rev. 653, 673.

109 Laura Nader, 'Controlling Processes in the Practice of Law: Hierarchy and Pacification in the Movement to Re-Form Dispute Ideology' (1993) 9 Ohio St. J. on Disp. Resol. 1, 13.

110 Refer section on "Structural Procedural Injustice".



to such a situation as to demand formal solutions evidences the fact that relations have broken down. At most, what one acquires is a “truce”, preferable simply because it can be attained without too many expenses and on the parties’ own terms.<sup>111</sup> The persistent lack of justice that negotiations and mediations inhere therefore deserves to be accorded a prominent position in scholarly discussions regarding negotiations and mediations, given the tremendous impact they have on the society.

## II. Conclusion

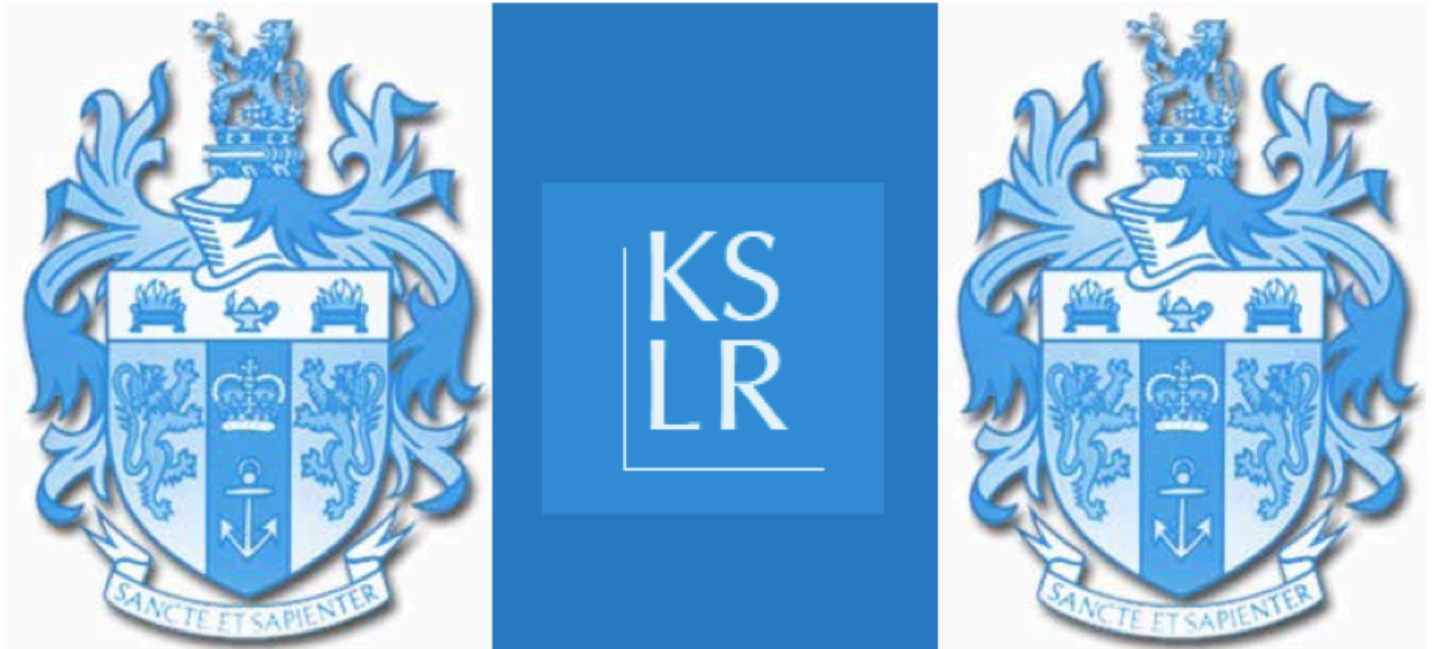
‘Objective justice’ is something that can rarely be achieved in negotiations, given the inherent structural, psychological and other barriers that they present. But ‘justice’ is that overarching, albeit elusive, concept which each of us seek in our daily life. It is an enduring ideal that governs the society that each of us is a part of, something without which society would collapse into disorder. As Bronsteen put it, “justice is a public good, objectively conceived, and is not reducible to the maximization of the satisfaction of the preferences of the contestants, which, in any event, are a function of the deplorable character of the options available to them.”<sup>112</sup> To live in a social construct where we adopt an ‘each-man-to-his-own’ approach and have disputes resolved on the benchmark of private parties’ satisfaction rather than a higher ideal is worrisome indeed. If negotiations and mediations, for all their cost-and-time-reduction techniques, do not ensure justice, are they still acceptable? If they are encouraged as more effective alternatives to litigations and are touted to provide better ‘access to justice’ than the courts,<sup>113</sup> isn’t it our duty to question if besides the “access”, the “justice” promised is being secured as well? Framed in this manner, one might now come to see why ‘objective justice’ considerations are crucial, despite the obvious satisfaction of the parties to the negotiation. Societal harmony and social order is fundamentally premised on the notions of justice and good faith, and negotiations and mediations, as methods of dispute resolution, disturb the very foundation that society is built on. It is essential to restore justice to the position it deserves as part of human efforts to resolve disputes and solve problems, and hopefully, the small attempt made towards this end in this article will open people’s eyes to this requirement.

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111 Fiss, O.M. ‘Against Settlement’ (1984) 93 Yale Law Journal 1073, 1075.

112 See John Bronsteen, ‘Some Thoughts About the Economics of Settlement’ (2009) 78 Fordham Law Review 1129 cited in Fiss, ‘The History of an Idea’ (2009) 78 Fordham Law Review 1273.

113 S. Brown, C. Cervenak and D. Fairman, ‘Alternative Dispute Resolution Practitioners’ Guide’ <[http://www.usaid.gov/our\\_work/democracy\\_and\\_governance/publications/pdfs/pnacb895.pdf](http://www.usaid.gov/our_work/democracy_and_governance/publications/pdfs/pnacb895.pdf)> (A Publication by the Centre for Democracy and Governance, United States Agency for International Development, 1998) (accessed on 4 June 2012), 1, 3.



**Case Comment: Balancing  
Freedom of Religion in the  
Workplace, Eweida and  
Others v the United Kingdom  
(Application numbers 48420/10,  
59842/10, 51671/10 and 36516/10)**

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**Abstract**

*On the 15 January 2013 the Fourth Section of the European Court of Human Rights handed down its highly anticipated judgment in *Eweida and Others v The United Kingdom*. The case concerned the challenge by four applicants against the United Kingdom ('UK') regarding the alleged infringement of their rights under Article 9 (freedom of thought, conscience and religion) and Article 14 (prohibition of discrimination) of the European Convention on Human Rights (hereafter the 'Convention'). The first and fourth applicant (Ms. Eweida and Mr. McFarlane respectively) were employed by private companies, and thus the Court was required to determine whether, in all the circumstances, the State authorities complied with their positive obligation under Article 9 to ensure that the applicants' rights were sufficiently secured within domestic law. The second and third applicants' claims were against national authorities, and thus the Convention rights were invoked directly against the State, requiring the Court to determine whether there had been an interference with their Article 9 rights.*

*The Court held that the first applicant had suffered an infringement of her Article 9 rights that could not be justified by Article 9(2). The complaints of the second, third and fourth applicants were dismissed.*

**Facts and Submissions***(i) First applicant*

Ms. Eweida was a practising Christian who, from 1999, worked as check in staff for the private company British Airways Plc. British Airways operate a strict uniform policy, and in 2004 produced a new *wearer guide* to coincide with the introduction of new uniforms. The guide stipulated that '[a]ny accessory or clothing item that the employee is required to have for mandatory religious reasons should at all times be covered by the uniform.' If the nature of any item was such that this policy could not be complied with, approval was required from local management, unless approval was already contained within the uniform guidelines. Items that British Airways considered to be mandatory for religious reasons that were unable to be concealed included the Sikh turban and the Muslim hijab. These were only permitted in British Airways approved colours.

In May 2006 Ms. Eweida began wearing a cross on the outside of her uniform as a sign of her commitment to her faith, and in breach of the uniform guidelines. On several occasions she was requested to conceal the item, which she reluctantly did. Subsequently, on 20 September 2006, she refused to remove the cross and was sent home without pay until she chose to attend work in compliance with the uniform code, as per British Airways practice. On 23 October 2006 she was offered administrative work in a non-customer facing role, without uniform requirements, but she refused this offer.

After considerable media attention concerning Ms. Eweida's case, British Airways began a review of its uniform policy in November 2006 regarding the wearing of religious symbols, which included consultation with staff members and trade union representatives. It was decided that, with effect from 1



February 2007, the display of religious symbols was permitted where authorised, and the cross was given immediate authorisation. Ms. Eweida returned to work on 3 February 2006, but British Airways refused to compensate her for the loss of earnings during the period in which she was away from work.

The Employment Tribunal rejected Ms. Eweida's claim for indirect discrimination, contrary to Regulation 3 of the *Employment Equality (Religion and Belief) Regulations 2003*, and the claim of a breach of her right to manifest her religion under Article 9. The Employment tribunal did not deem the wearing of the cross to be a mandatory requirement of her religion, and that as no other Christians had complained, there had been no general disadvantage to establish indirect discrimination. The Employment Appeal Tribunal rejected her appeal in November 2008 and held that the concept of indirect discrimination implied the necessity for group disadvantage, and that evidence to this effect had not been established.<sup>1</sup> Similarly, the Court of Appeal in February 2010 rejected her appeal on the grounds that evidence of group disadvantage was needed to establish indirect discrimination.<sup>2</sup> The Court also did not consider Ms. Eweida's case under Article 9, and referred to the judgment of Lord Bingham in *R(SB) v Governors of Denbeigh High School*<sup>3</sup> where it was held that the Strasbourg institutions were not forthcoming in finding an interference with the freedom to manifest religion when employment that did not accommodate the practice in question had been voluntarily accepted.<sup>4</sup> On 26 May 2010 she was refused leave to appeal to the Supreme Court.

Ms. Eweida complained to the European Court of Human Rights that the sanction that she suffered at work breached her Convention rights under Article 9, taken alone or in conjunction with Article 14. Broadly, three submissions were made:

1. The visible displaying of a cross was a generally recognised form of practising Christianity, and, in any event, this test for engaging Article 9 ECHR, as formulated by the Government, was incorrect. It was vague and required courts to enter theological debate, which was beyond their competence.
2. To be restrictive in the interpretation as to what constituted an interference with Article 9 ECHR would be inconsistent with freedom of religion being a fundamental right. No other right of this nature is restricted in the sense that it is possible to avoid the interference by finding alternative employment. Any other means of avoiding the restriction should only be considered under Article 9(2) when considering whether the restriction was justified, and was not relevant to the consideration under Article 9(1) of whether that had actually been any interference. It is

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<sup>1</sup> [2009] ICR 303

<sup>2</sup> [2010] EWCA Civ 80

<sup>3</sup> [2006] UKHL 15

<sup>4</sup> Ibid [23] (Lord Bingham)



submitted in this case that there was a clear interference, as Ms. Eweida was prevented from displaying her cross, and she suffered a loss of earnings.

3. There was an ongoing failure in domestic law to give adequate protection to Ms. Eweida's Article 9 rights, as she was denied the protection to manifest her religious belief. As there was no evidence that the wearing of the cross was a widely practiced manifestation of her Christian belief, she was unable to prove group disadvantage. This precluded her from making a successful claim of discrimination, despite also being inherently vulnerable to returning arbitrary results.

*(ii) Second applicant*

Ms. Chaplin was similarly a practising Christian who chose to express her belief by the wearing of a cross on a chain around her neck. She believed that to remove her cross would be a violation of her faith. She was employed in a State hospital by Royal Devon and Exeter NHS Foundation Trust from April 1989 to July 2000, with exceptional employment history, and at the time of the events in question was working as a geriatric nurse. The hospital's uniform policy was based on guidelines produced by the Department of Health, and provided that any jewellery that was worn must be discreet. Furthermore, under paragraph five, jewellery was to be kept to a minimum to decrease the risk of cross infection, and that no necklaces were to be worn when handling patients to reduce the risk of injury. If for religious or cultural reasons, staff wished to wear particular items of clothing or jewellery, they were to seek the approval of management who would not unreasonably withhold approval.

Evidence before the Employment Tribunal showed that other Christian staff had been requested to remove a cross and chain, Sikh nurses had been requested to remove their bangle or kirpan, and Muslim nurses had been required to wear a close fitting 'sports' hijab that resembled a balaclava helmet. They had all complied with these requests. In June 2009 Ms. Chaplin's manager requested that she remove her cross and chain, and she was refused approval to wear the religious symbol on health and safety grounds as the chain may cause injury if a patient pulled on it. Furthermore, the chain may also come into contact with open wounds, and therefore Ms. Chaplin's suggestion of wearing a chain secured by magnetic catches did not present a viable alternative. It was suggested to Ms. Chaplin that she may wear the cross attached to her lanyard which held her identity badge. However, she rejected this suggestion, as this badge was also required to be removed when performing clinical duties. Ms. Chaplin was then moved to a non-nursing position in November 2009, which ceased to exist in July 2010.

She made complaints of both direct and indirect discrimination to the Employment Tribunal in November 2009. In May 2010 the Tribunal held that there had been no direct discrimination as the hospital had based its stance on health and safety grounds as opposed to religious grounds. Furthermore,



there was found to be no indirect discrimination as there was no evidence of group disadvantage, as it could not be shown that anyone other than the applicant had been put at particular disadvantage. The response of the hospital to the request by Ms. Chaplin to wear her cross visibly had also been proportionate.

The applicant was advised that, following the case of Ms. Eweida in the Court of Appeal, an appeal to the Employment Appeal Tribunal would have no prospect of success. Ms. Chaplin complained to the European Court of Human Rights under Article 9, taken alone or in conjunction with Article 14, and made three substantive submissions;

1. The wearing of a cross was clearly a recognised aspect of Christianity, and it was wrong to distinguish between 'requirements' and 'non-requirements' of a religion with the intention that the protection afforded by Article 9 should only extend to 'requirements'. This would set the threshold for protection too high, and give a higher level of protection to more prescriptive religions.
2. Recent case law of the Court and the Commission does not support the contention, made by the Government, that a requirement to remove or conceal her cross did not constitute an interference with her right to manifest her religion or belief.
3. The interference was not justified under Article 9(2), as no evidence had been adduced that the wearing of the cross presented a health and safety problem. Furthermore, the difference in treatment between Ms. Chaplin and other employees of religion constituted a breach of Article 9 taken in Conjunction with Article 14.

*(iii) Third applicant*

The third applicant, Ms. Ladele, was a Christian who believed that marriage is a union between a man and a woman for life, and that same-sex unions were contrary to the law of God. She was employed from 1992 by a public authority, the London Borough of Islington. The public authority had a 'Dignity for All' equality and diversity policy. Under this policy the council strived to 'promote community cohesion and equality for all groups', with specific reference being made to sexuality, and pledged that all discriminatory barriers that prevent people from obtaining the services and employment opportunities that they are entitled to would be removed.

Ms. Ladele, in 2002, became a registrar of births, deaths and marriages. She was paid by the local authority and thus had a duty to abide by its policies, but was employed and held office under the aegis of the Registrar General. The *Civil Partnership Act 2004* provided for the legal registration of same-sex civil



partnerships, and in 2005 the local authority designated all of the existing registrars as civil partnership registrars. It was only required by the legislation that a sufficient number of registrars in a local authority be able to carry out civil partnerships, and other local authorities had allowed registrars to opt out of the role should they have sincerely held religious objections.

Initially, Ms. Ladele was able to make informal arrangements with other colleagues to relieve herself of civil partnership duties; however, two colleagues complained in March 2006 that this practice was discriminatory. The local authority informed her in April 2006 that she was in breach of both the Code of Conduct and the equality policy. Ms. Ladele refused to comply with the requests that she should conduct civil partnerships, and requested that the local authority should accommodate her religious beliefs. Her continuous refusal to perform these duties affected both staff morale within the office, and presented logistical problems for the local authority when compiling rotas. Following complaints of victimisation from homosexual colleagues in May 2007, the local authority conducted a preliminary investigation, which recommended in July 2007 that Ms. Ladele should be subject to a formal disciplinary complaint as her refusal to carry out civil partnerships on the ground of the sexual orientation of the parties violated the Code of Conduct and the equality policy. After a disciplinary hearing in August 2007, she was asked to agree to a new job description that required her to carry out straight forward signings of the civil partnership register and administrative duties, but with no obligation to conduct ceremonies.

Ms. Ladele complained to the Employment Tribunal of direct and indirect discrimination on the grounds of religion or belief and harassment. In the meantime, the *Statistics and Registration Act 2007* came into force on 1 December 2007, with the effect that Ms. Ladele then became employed directly by the local authority, and it was advanced that if she lost proceedings it would be likely that she would be dismissed. In July of 2008, the Employment Tribunal upheld Ms. Ladele's complaint. This was subsequently reversed by the Employment Appeal Tribunal in December 2008,<sup>5</sup> as the treatment of Ms. Ladele had been a proportionate means of achieving the legitimate aim of providing the registrar service on a non-discriminatory basis. The Court of Appeal also upheld this in December 2009, and held that 'Ms. Ladele was employed in a public job and was working for a public authority; she was being required to perform a purely secular task'.<sup>6</sup> Moreover, 'Ms. Ladele's objection was based on her religious view on marriage, which was not a core part of her religion; and Islington's requirement in no way prevented her from worshipping as she wished'.<sup>7</sup> The Court concluded that Article 9 of the Convention did not allow respect for her religious views to override the consideration of equal respect for both the homosexual and heterosexual community. She was refused leave to appeal to the Supreme Court on 4 March 2010.

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<sup>5</sup> [2009] ICR 387

<sup>6</sup> [2009] EWCA Civ 1357 [52] (Dyson LJ)

<sup>7</sup> Ibid





Ms. Ladele complained to the European Court of Human Rights only under Article 14 taken in conjunction with Article 9, as opposed to Article 9 alone, as she believed that she had been discriminated against on the grounds of religion. Furthermore, she contended that the failure of the local authority to treat her differently from other staff that did not have a conscientious objection, constituted indirect discrimination. She also claimed that the refusal of the local authority to use less restrictive means was disproportionate under Article 14 and Article 9.

Ms. Ladele further submitted that the Court should, as with other suspect grounds, require 'very weighty reasons' in order to justify discrimination on the grounds of religion. Whilst she accepted that the aim pursued by the local authority to provide indiscriminate access to services was legitimate, she did not accept that there was a reasonable relationship of *proportionality* with the means applied. The local authority had discretion not to designate her as a registrar of civil partnerships, and could have accommodated her religious belief whilst still providing a full and effective civil partnership service. Ms. Ladele did not manifest any prejudice towards homosexuals, and had the local authority accommodated the applicant it would not have been seen as approving of her beliefs. The local authority failed to adhere to its duty of neutrality, and did not strike a balance between delivering the service in a non-discriminate way to the LGBT community and the non-discriminate treatment of its employees.

(iv) *Fourth applicant*

Mr. McFarlane, the fourth and final applicant, was a practising Christian, who held the deep religious conviction that the Bible states that homosexual activity is sinful and should not be endorsed. He worked for Relate Limited, a private organisation that provides a confidential sex therapy and relationship counseling service, from May 2003 until March 2008. Relate and its counselors abide by the *Code of Ethics and Principles of Good Practice*, set by the British Association for Sexual Relationship Therapy. This code prohibits a therapist from 'impos[ing] a particular set of standards, values or ideals upon clients' and requires that they 'work in ways that respect the value and dignity of clients' (paragraph 18) and to 'be aware of their own prejudices and avoid discrimination' (paragraph 19). Furthermore, an *Equal Opportunities Policy* was in place, which prevented the less favourable treatment of trustees, staff, volunteers, counselors or clients on the basis of personal or group characteristics.

Mr. McFarlane had some initial concerns about providing counseling to same-sex couples. In 2007 he began Relate's postgraduate diploma in psychosexual therapy, but there was an increasing perception within the organisation that he was unwilling to work on sexual issues with homosexual couples. Following a meeting with management in October 2007, in which Mr. McFarlane expressed his concerns with the irreconcilable requirement that he provide counseling to same-sex couples and the teachings of the Bible, he was advised that it would not be possible to filter clients to prevent him from working with LGB couples. He refused to confirm if he would carry out psycho-sexual work with same sex-couples



following concerns expressed by other counselors in December 2007. As a result, he was suspended, pending a disciplinary investigation. After two investigations were conducted, along with a hearing in March 2008, Mr. McFarlane was summarily dismissed for gross misconduct, as he had no intention of providing counseling to same-sex couples and was in breach of the Equal Opportunities Policies. His appeal was rejected at an appeal meeting on 28 April 2008.

Mr. McFarlane complained to the Employment Tribunal of direct and indirect discrimination, unfair dismissal and wrongful dismissal. In January 2008 it was held that he had not suffered direct or indirect discrimination, as his dismissal was not based on religious grounds, and the requirement that counselors comply with the Equal Opportunities Policy was a proportionate means of achieving the legitimate aim of a full range of counseling to *all members* of the community. Filtration of clients did not protect clients from potential rejection by Mr. McFarlane. Furthermore, due to the loss of confidence in Mr. McFarlane, the claim for unfair dismissal also failed. This was upheld by the Employment Appeal Tribunal on 30 November 2009, which rejected his argument that it was not legitimate to distinguish between objecting to a religious belief and objecting to an act that manifested that belief.<sup>8</sup> It was held that this practice was compatible under Article 9 of the Convention. Mr. McFarlane was twice refused permission to appeal to the Court of Appeal, following the Court's judgment in 2009 of Ms. Ladele's case, as there was no real prospect of success.<sup>9</sup>

Before the European Court of Human Rights Mr. McFarlane complained of a breach of his Convention rights under Article 9, taken alone or in conjunction with Article 14, and made two submissions;

1. It is incorrect to assert, as the Government had, that not every act motivated or inspired by religious belief would be protected. Adherence to a religious sexual morality was a valid manifestation of belief. The proper standard for determining whether an interference of a right guaranteed by Article 9 was justifiable was to determine whether it was necessary in a democratic society and proportionate to a legitimate aim being pursued. When determining the margin of appreciation allowed to the State in restricting religious freedom the Court must take into account the need to maintain religious pluralism as a concept inherent to a democratic society. Article 9 would be ineffective if it only protected private manifestation of faith.
2. Damage to professional reputation caused by dismissal from employment was a severe consequence for Mr. McFarlane. As he was employed by a private company, there was no statutory obligation to provide the counseling service, and Relate could feasibly have filtered homosexual clients to other counselors. It was unreasonable to expect Mr. McFarlane to change his job or career to secure his religious freedom.

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<sup>8</sup> [2010] ICR 507

<sup>9</sup> [2010] EWCA Civ 880



(v) *The Government*

The Government submitted that, in respect of the claims invoking Article 9 alone, Article 9 does not protect *every act* that is inspired or motivated by a religious belief. If the practice was not a *generally-recognised* form of manifestation of the belief, then Article 9 would not protect it. Following this, it did not deem the wearing of the cross as a mandatory requirement of the Christian faith, and that it was not a generally recognised form of practice. Therefore, Article 9 did not protect the applicant's claims. Furthermore, Mr. McFarlane's objection to providing the psychosexual counseling was not a generally recognised form of practising the Christian faith.

If, however, it was accepted by the Court that the wearing of the cross or refusal to provide services to homosexuals was a true manifestation of religious belief, the Government submitted that there had been no interference with the right. The voluntary acceptance of employment relationships that do not accommodate religious practice, when there are other means open to the claimants by which to practise and observe their religion without undue hardship, will preclude any claim that their Article 9 right has been interfered with; *R(SB) v Governors of Denbeigh High School*<sup>10</sup> considered. Both Ms. Eweida and Ms. Chaplin were offered alternative employment arrangements that would allow them to visibly wear their cross, and Ms. Ladele was free to manifest her religious beliefs in any way that she wished outside of work. Each applicant was also free to resign and seek employment elsewhere in a more accommodating establishment, which was sufficient to guarantee their Article 9 Convention rights. Furthermore, Ms. Eweida and Mr. McFarlane were employed by private companies, and therefore their complaints were not of direct intervention by the State, but rather that the State had not done all that was required of it under Article 9 ensure that private employers permitted them to give expression to their religious views at work. The Government submitted that sufficient domestic measures had been adopted to secure the free practise of religion.

If the Court did establish a breach of Article 9 rights in the present cases, the Government further submits that the measures taken by the employer were a proportionate means of achieving a legitimate aim. As regards Ms. Eweida, British Airways was fully entitled to impose a contractual uniform code with the intention of maintaining a professional image and reinforcing the company brand. In any event, Ms. Eweida chose not to raise her concerns with the requirements, but simply chose to breach them and then further reject the offer of alternative employment in favour of remaining at home. The Government also submit that, as regards Ms. Chaplin, the restriction was a proportionate means of achieving the legitimate aim of reducing the risk of injury when handling patients; especially as she was also offered alternative employment which would allow her to display her cross. The Government also recognised that Ms.

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<sup>10</sup> [2006] UKHL 15



Ladele and Mr. McFarlane held sincere religious beliefs regarding homosexuality. However, as both employers were committed to providing a non-discriminatory service, it was proportionate for the employers to expect staff to deliver the relevant services without discrimination on the grounds of sexual orientation. Domestic legislation balances between the right to manifest religious beliefs and the right not be discriminated against on the grounds of sexual orientation. It is however within the margin of appreciation accorded to the State under Article 9 to decide exactly how this balance should be achieved.

*(vi) The third parties*

A total of twelve third parties submitted written comments. A number of comments were submitted on the issue as to whether wearing a cross could be considered as a manifestation of religious belief. Several comments contended that the cross was a universally recognised and self-evident manifestation of the Christian faith, and that a subjective approach should be taken when assessing manifestations of religious belief (advocated by the Equality and Human Rights Commission). The idea that it needs to be a mandatory requirement to attract the protection of Article 9 was too restrictive.

A number of interveners asserted that it was incorrect to make an employee choose between their job or career and their faith. This was an invidious choice, and it did not secure religious freedom. However, the National Secular Society asserted that the 'freedom to resign is the ultimate guarantee of freedom of conscience'.

Finally, a number of the interveners made reference to the concept of 'reasonable accommodation' (as found on the Canadian and United States of America jurisprudence), and that this should be taken into account when the Court engages in a proportionality analysis. Some compromise between competing rights is necessary in a democratic society, and provided that the religious practice did not cause a detrimental effect to the employer or their provision of service, those religious practices should be protected. Furthermore, Liberty submitted that the State enjoys a large margin of appreciation when considering the justification for the interference with an Article 9 right, with the National Secular Society drawing attention to the 'conscientious objection' provision that Parliament had given detailed consideration to throughout the passage of the Equality Bill.

## **Judgment**

*(i) First applicant*

The Court declared the first, third and fourth applicants' complaints admissible. The second applicant's case was admissible in relation to the claim under Article 9, but not the claim of Article 9 in conjunction



with Article 14. The applicant had failed to exhaust all domestic remedies. The Employment Tribunal, on the evidence before it, had been unable to find that she had been treated less favourably than employees of other religions. If there were grounds to challenge this finding of fact, she should have raised them in the Employment Appeal Tribunal. Article 35 of the Convention rendered this part of the application inadmissible, as that was appeal was not brought.

The Court considered that Ms. Eweida's decision to wear the cross was a manifestation of her religious belief that attracted the protection of Article 9, and the refusal by British Airways to allow her to remain in her check-in role whilst displaying the cross amounted to an interference with her rights under Article 9. As Ms. Eweida was employed by a private company, the Court had to determine whether the State authorities had complied with the positive obligation under Article 9 to sufficiently secure her rights within the domestic legal order, and a fair balance struck between the relevant competing rights. The United Kingdom does not have legal provisions specifically governing the wearing of religious symbols and clothing in the work place, and it was not within the jurisdiction of the Employment Tribunal to consider the case under Article 9 of the Convention (and which subsequently was only able to be invoked, albeit unsuccessfully, before the Court of Appeal). However, it was clear that the British Airways uniform policy, and its proportionality, had been examined in detail. Therefore, the Court did not deem that the lack of specific domestic legislation regarding the wearing of religious symbols at work to be indicative of inefficient protection of Article 9 rights by the State. The Court further considered that the dress code was for a legitimate aim, Ms. Eweida defied the policy rather than lodge formal grievance procedures, the issue was conscientiously addressed by British Airways who relaxed the code, and Ms. Eweida was offered alternative employment on identical pay and then reinstated in her old role. These factors combined to mitigate the interference suffered. Furthermore, in weighing the proportionality of measures taken by private companies, the State was given a margin of appreciation within which to operate. Nonetheless, the Court reached the conclusion that, in the present case, a fair balance had not been struck between the competing issues. The domestic courts accorded too much weight to the legitimacy of the uniform code, Ms. Eweida's cross was discrete, and there was no evidence that the wearing of other permitted religious garments had detracted from the British Airways brand image. The amendment of the uniform code further suggested that the initial prohibition was unnecessary. The Court therefore concluded that, as there is no evidence of encroachment on the interests of others, the State authorities had failed to adequately protect Ms. Eweida's right to manifest her religion, thus breaching the positive obligation under Article 9 of the Convention. Following this conclusion, the Court did not find it necessary to examine the applicant's claim under Article 14 taken in conjunction with Article 9.

*(ii) Second applicant*





The Court held that the second applicant, Ms. Chaplin, also wore her cross as a manifestation of her religious belief, and that the refusal of the health authority to allow this was an interference with her Article 9 Convention rights. As Ms. Chaplin's employer was a public authority, it was for the Court to decide whether the interference was necessary under Article 9(2). In this case it is clear that the restriction on the wearing of jewellery and religious symbols was motivated by the concern for the health and safety of both the nurses and the patients. Furthermore, there was evidence before the Court that the health authority managers had valid concerns (such as a patient seizing the chain, or it coming into contact with an open wound) and other religious observers had been required to remove their jewellery and symbols. Ms. Chaplin had been offered alternative methods of wearing her cross that were in compliance with such health and safety concerns, which she declined.

The Court considered, as it did with Ms. Eweida, that the importance for the second applicant of being able to wear her cross as a manifestation of her religious belief should weigh heavily in the balance. However, health and safety in the hospital environment was a consideration of a greater magnitude than the reasons that applied for restricting the wearing of the cross by the first applicant (the uniform code). Furthermore, domestic authorities must be allowed a wide margin of appreciation on this field, as hospital managers were much better placed to make decisions regarding clinical safety than a court with no direct evidence. Therefore, the Court was unable to conclude that the measures applied to Ms. Chaplin were disproportionate, and as such, the interference with her religious belief was necessary in a democratic society and not a violation of her Article 9 Convention rights. The factors to be considered when assessing the proportionality of the measure under Article 14 in conjunction with Article 9 would be similar, and therefore there is no basis to find a violation of Article 14 in this case.

*(iii) Third applicant*

The third applicant, Ms. Ladele, complained that she had suffered discrimination in breach of Article 14 taken in conjunction with Article 9. The Court believed that it was clear that the applicant's objection to participating in same-sex civil partnerships was directly motivated by her religious beliefs, and considered that the relevant comparator was a registrar with no objection to same-sex civil partnerships. The Court agreed with the applicant that the requirement by the local authority for all registrars to preside over same-sex unions had a detrimental impact on her because of her religious beliefs, the Court however also held that that the aim pursued by the local authority (to provide equal opportunities and all services non-discriminately) was legitimate. It was then for the Court to determine whether the means used to pursue this aim were proportionate. Previous case law concerning Article 14 has held that different treatment on the grounds of sexuality requires serious justificatory reasons.<sup>11</sup> Whilst the Court acknowledged that the consequences for Ms. Ladele were severe, and it cannot be said that by entering a

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<sup>11</sup> For example *Karner v Austria*, no 40016/98 §37, ECHR 2003-IX; *Schalk and Kopf v Austria*, no 30141/04 §97 ECHR 2010



contract of employment she waived her rights to manifest her religious belief, the policy of the local authority was aimed at protecting the Convention rights of others. The Court generally allows a wide margin of appreciation to national authorities when striking a balance between competing Convention rights, and in this instance concluded that the national authority had not exceeded the margin of appreciation available to them. There was therefore no violation of Article 14 taken in conjunction with Article 9.

*(iv) Fourth applicant*

The fourth applicant, Mr. McFarlane, was employed by a private company; therefore, as with Ms. Eweida, the Court was required to determine whether the State had fulfilled the positive obligation of securing the applicant's convention rights under Article 9. The Court accepted that Mr. McFarlane's negative belief about homosexual relationships was motivated by his religious beliefs, and his refusal to provide counseling to homosexual couples was a manifestation of this belief. In determining whether there was a fair balance struck between competing Convention rights, the Court considered the consequences suffered by Mr. McFarlane (such as the loss of his job) and his voluntary enrolment on the psycho-sexual training programme in the knowledge that this would include providing services to homosexual couples. Whilst voluntarily entering into an employment contract that the individual knows will restrict his ability to manifest a religious belief does not preclude the determination that there has been an interference with their Article 9 convention rights, it is a matter that should be considered in the balancing exercise. The Court held that the most important consideration was that the employer's action was intended to achieve their policy aim of providing a service without discrimination. In doing so the State benefitted from a wide margin of appreciation, which the Court did not feel had been exceeded. Therefore, the Court did not consider that the refusal of the domestic courts to uphold the complaints made by Mr. McFarlane gave rise to a violation of Article 9, taken alone or in conjunction with Article 14.

**Dissent**

*Joint partly dissenting opinion of Judges Bratza and David Thór Björgvinsson*

Both judges could not agree that the Article 9 Convention rights of Ms. Eweida had been violated. Despite the lack of domestic legislation regulating the wearing of religious symbols and clothing in UK employment law, it did not follow that in the facts of this case that Ms. Eweida's Article 9 rights had not been secured. Both the legitimacy of the aim and the proportionality of the uniform policy were extensively considered by the domestic courts, with the conclusion by the Court of Appeal that both requirements were met.



Judges Bratza and David Thór Björgvinsson did not find it possible to say that the Court of Appeal failed to carry out a fair balancing exercise, and contrary to the majority judgment, it was not the case that the domestic courts placed too much weight on British Airway's desire to maintain a certain corporate image. Furthermore, whilst the uniform code was altered, and was therefore clearly not of vital importance to the aim pursued, this does not mean that it was not of sufficient importance to maintain as British Airways conducted its review. Consequently, there was no violation of Article 9 read alone.

In relation to Ms. Eweida's claim of Article 14 read in conjunction with Article 9, both Judges found no reason to disagree with the conclusion that there had been no direct discrimination. The claim before the Court was one of indirect discrimination, the central feature of which is group disadvantage (which had not been proven). Submissions by the first applicant argued that that this requirement is an excessive burden, and discriminates against religions that were less prescriptive as to their manner of dress or traditions followed. Whilst the dissenting Judges acknowledged both these arguments, they opted to leave these questions unresolved. They held that even if the measure had given rise to a claim of indirect discrimination, there was in this case a reasonable and objective justification for the measures, and they were a proportionate means of achieving a legitimate aim. Therefore, there was no violation of Article 14 read in conjunction with Article 9.

*Joint partly dissenting opinion of Judges Vučinić and De Gaetano*

Both judges were unable to agree with the majority that there had been no violation of the Convention rights in respect of Ms. Ladele. They believed that Ms. Ladele's case was concerned more with her freedom of conscience as opposed to freedom of religion. The two concepts are distinct from one another; conscience is notably absent from Article 9(2) and is therefore not subject to this condition. The Judges adopted the view that a genuine and serious conscientious objection should attract both positive protection by the State, and the negative duty to refrain from acting against the objector. The Government accepted that Ms. Ladele's objection to conducting same-sex unions was genuine and serious, which also happened to be a manifestation of her religious belief, and therefore it should be worthy of protection.

Furthermore, when Ms. Ladele joined the public authority, there was no requirement, or indeed any indication that she may in future, be called upon to officiate a same-sex civil partnership. Even when this became a reality, the *Civil Partnership Act 2004* and the actions of other local authorities permitted compromises that would not require those who conscientiously objected to perform the services. This is in direct contrast with the fourth applicant (Mr. McFarlane), who reasonably knew at the time of entering employment that he may well be required to provide a service to same-sex couples. In addition, it is



irrelevant whether the margin of appreciation accorded to the State was wide or narrow, as in cases of moral conscience this is not a relevant consideration.

Judges Vučinić and De Gaetano noted that the complainant is neither a service user nor prospective service user, of the local authority. The legitimate aim of the local authority was also never in question. The Court cannot therefore carry out a balancing exercise between the applicant's concrete Convention right to conscientious objection and the legitimate local authority's policy seeking to protect rights in the abstract. There is therefore no determination as to whether the means that were used to pursue this aim were legitimate. Rather, the issue is the discriminatory treatment of Ms. Ladele, and that given her conscientious objection, the local authority should have treated her differently from those registrars who had no such objections to performing same-sex civil partnerships. This could have been achieved without damaging the quality and quantity of service provision, and was a policy adopted by a number of other local authorities.

Ms. Ladele maintained her discretion and never expressed her beliefs publicly, or to service users. Therefore, even if a proportionality exercise had been conducted it would be suitable to conclude that the means used in pursuing the legitimate aim were wholly disproportionate. For these reasons Judges Vučinić and De Gaetano conclude that there was a violation of Article 14 read in conjunction with Article 9.

### **Costs and Expenses**

Ms. Eweida claimed compensation for her loss of earnings with interest (totaling GBP 3,906.69) and non-pecuniary damage to her feelings, which at domestic level would have entitled her to an award of up to GBP 30,000. The Government submitted that a declaratory judgment would be sufficient, given that British Airways had modified the uniform policy. Furthermore, despite the finding of discrimination, Ms. Eweida did not suffer financial loss as she was offered alternative employment, and in fact received up to twice the level of her loss of earnings during the period of September 2006 to February 2007 through gifts, donations and other earnings. Therefore the Court felt that Ms. Eweida should not be compensated in respect of her loss of earnings, and instead chose to award Eur 2,000 in non-pecuniary damages. She claimed approximately Eur 37,000 for costs and expenses. After consideration of the documents before the Court, she was awarded Eur 30,000 together with any tax that would be chargeable.

### **Comment**

Previous case law of the Court has provided that the freedom to resign was the sole protection of Article 9 in the employment sphere. This has now been dispelled by the Court finding for Ms. Eweida and upholding the two-stage inquiry encapsulated by Article 9(1) and Article 9(2). Furthermore, it is now clear that the voluntary undertaking of an employment contract is no longer relevant when establishing a *prima facie* claim under Article 9(1), but rather only becomes relevant when assessing the justification



for interference under Article 9(2). This affirms the approach of the Court in *Leyla Şahin v Turkey*.<sup>12</sup>

It is significant that the Court held at paragraph 82, and against the submissions of the Government, that the manifestation of religious beliefs is not to be confined to acts that are mandatory under the relevant religion. This allows for a greater range of practices to fall within the scope of Article 9, and removes the inherent discrimination faced by religions that are less prescriptive in nature.

It is a positive step that a significant amount of the Court's analysis was spent on scrutinising the various reasons of the employers for not accommodating the religious beliefs of the applicants'. It is especially positive that they gave consideration to the various methods, and the burdens that these would entail, that could have been employed to reasonably accommodate these religious beliefs in the workplace.

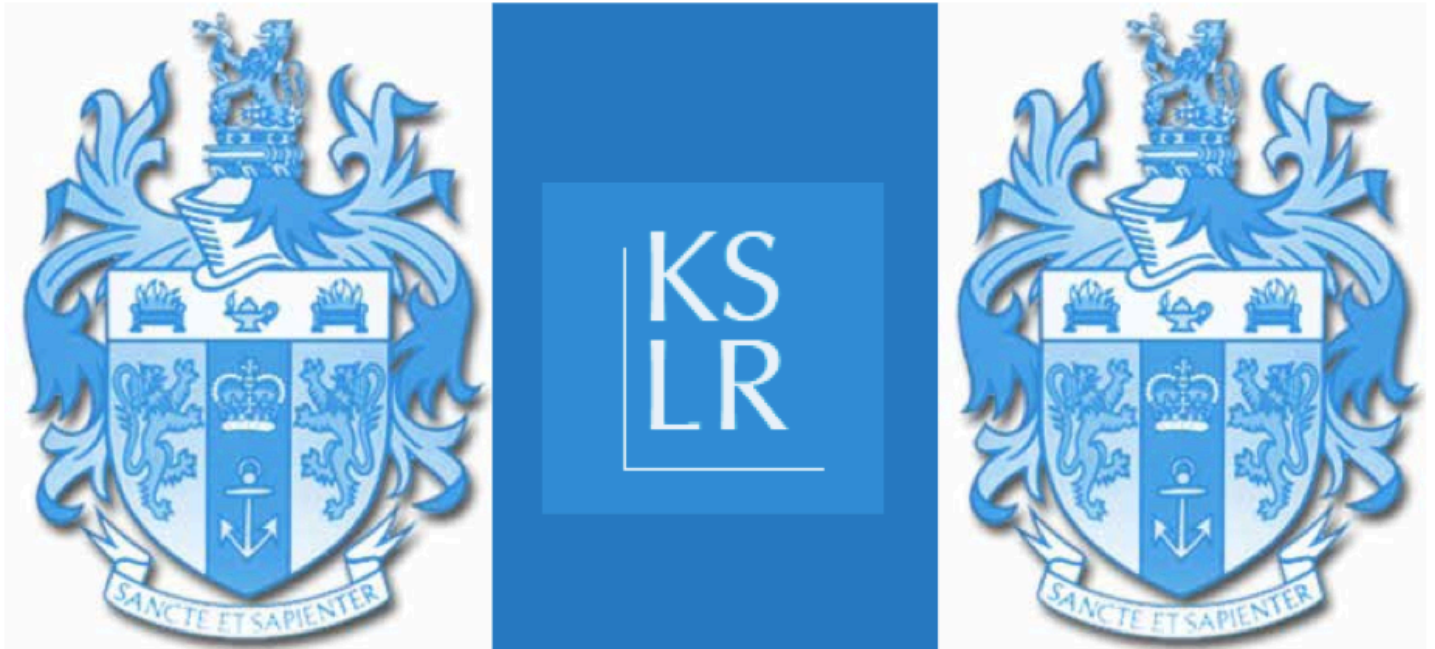
The Court largely left untouched the requirement for group disadvantage in indirect discrimination, and reasoned and concluded without explicitly removing this requirement. Indeed, the dissent of Judges Vučinić and De Gaetano completely dismissed the need to examine the issue when delivering their judgment. Therefore, whilst it is not wholly clear, it can be assumed that the requirement for a group disadvantage when claiming indirect discrimination under domestic UK law is still a necessity.

Finally, it is perhaps alarming that, in the dissenting judgment of Judges Vučinić and De Gaetano, it was felt necessary at paragraph 5 to compare gay rights to fundamental human rights. This suggests that the minority attitude of the Court believes that members of the homosexual community attract lesser rights than those of the heterosexual community. Homosexuality is a protected ground of discrimination under Article 14, therefore the protection from discrimination on this ground is a fundamental human right. It is unclear where the distinction between a gay right and a fundamental right would lie, as the homosexuality of an individual is an immutable characteristic that is a constituent part of their personhood; it does not reclassify them as not being entitled to the fundamental human rights that all those who do not possess the immutable characteristic enjoy. It is also unclear why the Judges felt it necessary to place the term gay rights in inverted commas in paragraph 5. This further suggests that gay rights are a concept that the minority felt was somewhat of a fiction, or an unserious consideration. Furthermore, when describing the complaints made by Ms. Ladele's homosexual colleagues, it is disconcerting that this was labeled as 'backstabbing'.

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<sup>12</sup> Application no. 44774/98





# **Searching, Suggesting and Speaking: Does a Company Have Recourse for Defamation on Google?**

**Donal Scott**

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Political Science



In 2005, Google's CEO Eric Schmidt estimated the total amount of data indexed and searchable by Google to be in the region of 170 terabytes.<sup>1</sup> The figure is obviously considerably higher today. The prospect of having such large volumes of information available and readily searchable online is both very exciting and somewhat worrying. From an economic perspective, the internet represents a great source of enterprise and growth. In 2009, online activities contributed a total of £100 billion to the UK economy, representing a larger contribution than any other industry.<sup>2</sup> Google has been eager to assert its role in promoting economic growth and helping business make money through e-commerce, noting that in 2011 it generated \$80 billion in economic activity for American businesses.<sup>3</sup>

Search engines are the portals through which the Internet is experienced, representing the main way in which information is sorted online.<sup>4</sup> In the words of Nissenbaum & Introna, "[t]o exist is to be indexed by a search engine".<sup>5</sup> Of these search engines, Google is unquestionably the most dominant, with a market share in the region of 66.8 percent. Its nearest rival, Microsoft Bing, remains far behind with a market share of 15.6 percent.<sup>6</sup> As Google becomes more and more dominant in its role of indexing and channeling online activity, the manner in which businesses interact with Google becomes essential for their survival.

Companies spend exorbitant sums of money in order to get onto the first page of Google search results.<sup>7</sup> This means that, for the most part, only the most well financed companies can get there. By making changes to its algorithm, the search engine giant can significantly alter how businesses conduct themselves online. This was seen when Google blacklisted the BMW and Ricoh German websites for prohibited "black hat" techniques. Both websites immediately responded by altering their website structures so as to conform to Google's guidelines.<sup>8</sup>

While having a high *PageRank* can be a major commercial advantage, Google represents a double-edged sword for businesses. Given the tendency to judge a company based on its Google *PageRank*, a low rank (comparative to competitors) can amount to a significant blow to a company's image. Similar damage can be caused by a prominent placement of disparaging content on Google's search results or in its search suggestions (known as *Autocomplete*).

This article will examine the relationship between corporate reputation and Google, with a specific emphasis on defamation. If a company is defamed through the operation of Google's services, how should the law respond to this? In attempting to answer this question, we will consider Google search results (in Part I) and Google's *Autocomplete* feature (in Part II). In considering both of these services,

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<sup>1</sup> Eric Schmidt, "Technology is Making Marketing Accountable" *Association of National Advertisers*, 8 October 2005.

<<http://www.google.com/press/podium/ana.html>>

<sup>2</sup> <<http://www.connectedkingdom.co.uk/the-report/>>

<sup>3</sup> <[www.google.com/economicimpact](http://www.google.com/economicimpact)>

<sup>4</sup> Emily Laidlaw, "Private Power, Public Interest: An Examination of Search Engine Accountability" (2009) 17(1) *Int J Law Info Tech* 113 at 118

<sup>5</sup> "Shaping the Web: Why the politics of search engines matters" (2000) 16(3) *The Information Society* 169 at 171

<sup>6</sup> Danny Goodwin, "Google, Bing Grow Search Market Share as Yahoo Continues to Wither" *Search Engine Watch*, 13 July 2012 <<http://searchenginewatch.com/article/2191367/Google-Bing-Grow-Search-Market-Share-as-Yahoo-Continues-to-Wither>>

<sup>7</sup> Derek Sturdy, "Search Engine Optimisation and Automatic Classification" (2010) 10 *Legal Information Management* 24

<sup>8</sup> Tom O'Flynn, "The Power of Google" (2006) 8 *Electronic Business Law* 3, 7



we will examine the issues in attributing publisher status to Google and any degree of speech protection it can be afforded. We will also look to Google's classification and obligations under the E-Commerce Regulations, with an aim of determining exactly what recourse a company will have where it suffers reputational harm through Google.

### **Part I – Google Search Results**

Much of a company's online image will be heavily influenced by how that image is reflected by Google. No matter how professional a company's website is, it won't be of great benefit if internet users are unable to find it in the first place. The difference between a top Google *PageRank* and appearing beyond the first page of search results is akin to the difference between having a retail outlet located in central New York and one located in rural Alaska. Research suggests that only 13.2% of search engine users will navigate beyond the first page of search results.<sup>9</sup> The importance of a high Google placement is further emphasised when one considers that 75% of internet users rely on search engines as their primary method of finding websites.<sup>10</sup> Thus, either you're on the first page, or your online presence is nonexistent for the majority of web users.

Google poses more direct threats to corporate reputation than a lack of publicity. A Google search can lead to direct negative publicity, capable of causing reputational damage. Take, for example, the phenomenon of "Google bombing". A Google bomb is a coordinated effort to artificially inflate the *PageRank* of a specific website in relation to a specific phrase. This technique was used to link a Google search for "McDonald's" with the top result of *Supersize Me* (a documentary film that is highly critical of McDonald's).<sup>11</sup> The result is that when a person seeks to learn more about McDonald's, their first point of reference is a decidedly negative view of that company. Furthermore, where defamatory comments are placed on a third party website, a high Google ranking of that website can transmit the comments to an audience exponentially larger than would have otherwise received it.

In light of the great influence Google has over how a company's online image is received, what redress would a company have in circumstances where Google's algorithm causes direct reputational damage? Such circumstances could refer either to an unfairly low *PageRank* for the company's website or a damaging search result to be artificially high in the list of results.

The standard remedy for instances of reputational damage is found in the tort of defamation. The general common law test in England is "whether an ordinary reasonable person would think less of the plaintiff because of what was said about him or her."<sup>12</sup> The main question that arises when considering Google's role in transmitting defamatory content is whether they can be viewed as responsible for "saying" it. Section 1 of the Defamation Act 1996 lays out three classes of person who can bear legal responsibility for a publication: an author, an editor, and a publisher. An author is

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<sup>9</sup> Van Couvering, "New Media? The Political Economy of Internet Search Engines", presented to the Communication Technology Policy section at the 2004 Conference of the International Association of Media & Communications Researchers at p 17

<sup>10</sup> Schulz et al, "Search Engines as Gatekeepers of Public Communication: Analysis of the German Framework Applicable to Internet Search Engines Including Media Law and Anti Trust Law" (2005) 6(1) *German Law Journal* 1419, at 1421

<sup>11</sup> Marziah Karch, "Google Bombs Explained" *About.com* <<http://google.about.com/od/socialtoolsfromgoogle/a/googlebombatcl.htm>>

<sup>12</sup> *Dee v Telegraph Media Group Ltd.* [2010] EWHC 924 (QB) at para 48



defined as the originator of the content. An editor is defined as the person with editorial responsibility for the content of the statement or the decision to publish it. A publisher is defined as a person whose business it is to issue material to the public.<sup>13</sup> Under these definitions, Google could be classified as either an editor or a publisher. By exercising control over its algorithm, Google makes editorial decisions based on the worth of the websites it assesses. While it may not conform to our conventional notion of an editor, laying down a list of rules to govern an autonomous editing process has the same outcome as a newspaper editor applying journalistic criteria when assessing the worth of an article. The publisher classification is perhaps more familiar, since Google's entire *raison d'être* is to make material readily available to the public (it defines its mission as "to organize the world's information and make it universally accessible and useful").<sup>14</sup> However, it could similarly be argued that Google doesn't actually publish the information it provides; rather it simply directs users to the location of information published by others. Under the common law approach, a company will have a complete defence to a defamation action if it can establish that it is not a publisher of the contentious statement.<sup>15</sup> Before we examine how the UK High Court has recently tackled this issue, it is useful to consider the US First Amendment position, given its greater line of jurisprudence on what constitutes speech.

### **Speech and the First Amendment**

While there is nothing controversial about imparting speech status to internet communications,<sup>16</sup> classifying an amalgamation of internet links as expression constitutes a more liberal definition of speech. Some contend that search results constitute "nonhuman or automated choices" and should not be regarded as speech at all.<sup>17</sup> Interestingly, Google itself readily asserts that its role in cataloging information amounts to speech. In a White Paper it commissioned in 2012, it is noted that just as a newspaper will face editorial decisions on what articles and features to include in their publication, Google has to make editorial decisions on what websites are most relevant to a search query.<sup>18</sup> The analogy falls apart somewhat when you consider that a newspaper makes editorial decisions pertaining to articles it creates, while Google's ranking (mainly)<sup>19</sup> concerns content created by others. In response to the potential argument that aggregation doesn't equate to speech, Google's white paper cites the case of *Hurley v Irish-American Gay, Lesbian & Bisexual Group*<sup>20</sup> where the U.S. Supreme Court held that a parade was entitled to First Amendment protection. Even though the parade was loosely organised and permitted anyone to march, it was still held to be advocating a message constituting expression. The argument provided is that, just like how the parade organisers aggregated the marchers but had no creative contribution to the content of their march, Google aggregates websites

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<sup>13</sup> Defamation Act 2006, section 1(2)

<sup>14</sup> <<http://www.google.com/intl/en/about/>>

<sup>15</sup> *Bunt v Tilley* [2007] 1 WLR 1243 at para. 37

<sup>16</sup> *Reno v American Civil Liberties Union* 521 U.S. 844 (1997)

<sup>17</sup> Tim Wu, "Free Speech for Computers?" *New York Times*, 19 June 2012

<sup>18</sup> Eugene Volokh & Donald Falk, "First Amendment Protection for Search Engine Search Results" *White Paper Commissioned by Google*, 20 April 2012, at 3

<sup>19</sup> Some Google results will pertain to websites that are operated by Google. This raises serious antitrust concerns where these websites are given artificially high rankings. See Kurt Wimmer, "The Proper Level for Constitutional Protection of Internet Search Practices" (2012)

<sup>20</sup> 515 U.S. 557



without authoring them.<sup>21</sup> A crucial distinction between these two instances is that it is far more difficult to glean a substantive message from Google's apparent speech. As noted by Souter's unanimous majority in *Hurley*, "we use the word 'parade' to indicate marchers who are making some sort of collective point"<sup>22</sup>. If there is no message being put forward, a parade amounts to little more than a trip from one destination to another; an activity which could not be regarded as expression. So then, what message is Google putting across when it returns a list of search results?

Put into words, the only clear message to be found in a list of search results is: "these websites are most relevant to your query." There isn't any commentary on political, social, or commercial issues; there isn't any commentary on any issue other than what websites best reflect a word or phrase. If this is to be considered expression, it has been likened to "the online equivalent of pointing and grunting".<sup>23</sup> Google has previously attempted to downplay its role in imparting messages in its search results, noting "results are not 'new' statements authored by Google or statements with meaning that is different or independent of the content of the underlying page."<sup>24</sup> If this argument seems contradictory to the claims made in the White Paper, the fact that in this instance Google was attempting to escape defamation liability by denying publisher status while in the White Paper it was trying to establish a First Amendment defence, might explain it.

The prospect of extending First Amendment "speaker" status to Google has found support amongst some district courts. In *Search King v Google Technology Inc.*<sup>25</sup> the plaintiff (who operated a "link farm" to improve clients' *PageRank*) raised a tortious interference claim when Google demoted the *PageRank* of its clients. Judge Miles La Grange held for Google, reasoning that search results constitute protected speech because they express an opinion as to "the significance of particular web sites as they correspond to a search query."<sup>26</sup> It is questionable whether an automated process can truly constitute an opinion in this manner, an issue that the judge neglected to comment on. For example, should I type a grammatically incorrect statement into Microsoft Word, its spell-check feature will alert me to that error and suggest alternative wordings. These wordings are based on the programming of the Microsoft developers and constitute an opinion that: (a) the grammatical structure of my sentence is flawed, (b) the suggested alternatives are correctly worded, and (c) they reflect the meaning I wish to convey. However, claiming the amended statement constitutes expression from the perspective of Microsoft casts the First Amendment net far too wide. While the coding of the Spell-check software may constitute speech<sup>27</sup> (the same argument could be made for Google's algorithm), claiming that each corrected sentence amounts to an occasion of Microsoft speaking would stretch the First Amendment to absurd limits.

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<sup>21</sup> Google White Paper, at 15 and 16

<sup>22</sup> *Hurley* at 568

<sup>23</sup> James Grimmelman, "Are Search Results Speech?" (2012) Early unpublished draft, accessible from [www.stanford.edu](http://www.stanford.edu)

<sup>24</sup> Combined Respondent's Brief as to the Merits and Cross-Appellant's Opening Brief as to Fees 15, *Maughan v. Google Tech., Inc.*, No. B183969, 2006 WL 1286841 (Cal. App. Feb. 27, 2006)

<sup>25</sup> 2003 W.L. 21464568 (W.D.Okla)

<sup>26</sup> *Ibid.* at p.4

<sup>27</sup> Lee Tien, "Publishing Software as a Speech Act" (2000) 15 *Berk. Tech. L.J.* 629





A second instance in which a US district court held that Google search results amounted to protected speech was seen in *Langdon v Google Inc.*<sup>28</sup> where the Delaware District Court dismissed the plaintiff's claim that Google ranked it unfairly. The Court held that search results are protected speech and to order Google to rank a website in a certain manner would constitute compelled speech, something the First Amendment is loathe to permit.<sup>29</sup> Rather unhelpfully, the Court neglects to expand upon how exactly this move would compel Google to speak. It could be argued that the speech is manifested by forcing Google to make amendments to its algorithm. Alternatively, and perhaps more likely, the reasoning applied could be that it would force Google to host the substantive content of the contentious results.<sup>30</sup> This would force an editorial action upon Google in the same manner as a newspaper editor being ordered to include certain content in his publication.<sup>31</sup> The unmentioned distinction, however, is that unlike the newspaper editor, no one would view a search result as a conscious endorsement. An article that appears in a newspaper can be viewed as the newspaper (or its staff) endorsing and approving of the messages contained therein (whether factual or evaluative). When Google displays a URL on its results page, it doesn't endorse<sup>32</sup> the content of the website, it instead makes an objective determination of that website's characteristics (such as how closely it makes the query, the website's popularity, and the amount of external links to the website). As Google itself has noted: "Our search results are generated completely objectively and are independent of the beliefs and preferences of those who work at Google."<sup>33</sup>

### **The UK's recent pro-Google position**

While the above analysis reaches a conclusion contrary to the "speaker" position which Google itself endorses, the connotations of such an approach would be beneficial for Google from a defamation perspective. If Google is not "speaking" in any material way, it cannot be classified as an author/editor/publisher in relation to the Defamation Act. This result reflects the legal position at present in the UK. In the landmark case of *International Metropolitan Schools Ltd v Designtecnica and Google*,<sup>34</sup> the High Court held that Google was not liable for the defamatory content of its search results. Eady J. reasoned that, by providing a search service, Google merely plays the role of "facilitator". The facts of this case have a different slant to the American cases discussed above. Rather than involving a company suing Google over their position in search results, this involves a company suing Google over defamatory comments (written on another website) that were accessible via a Google search and displayed as "snippets". Despite this distinction, the classification of Google as a "facilitator" and not an author/editor/publisher when returning search results would appear to be applicable regardless of the context. The analogy was drawn between search engines and telephone operators. A telephone operator can facilitate the circulation of a defamatory comment, but it isn't

<sup>28</sup> 474 F. Supp. 2d 622, 629-630 (D. Del. 2007)

<sup>29</sup> *Miami Herald Publishing Co. v Tornillo*, 418 U.S. 241 (1974)

<sup>30</sup> Bracha & Pasquale, "Federal Search Commission? Access, Fairness, and Accountability in the Law of Search" (2008) 93 *Cornell Law Rev* 1149 at 1190

<sup>31</sup> Eric Goldman, "Search Engine Bias and the Demise of Search Engine Utopianism" (2006) 8 *Yale J.L. & Tech.* 188, at 192 (making the point that search engines make editorial decisions just like any other media company)

<sup>32</sup> *Rumsfeld v Forum for Academic & Institutional Rights Inc.* 547 U.S. 47 (2006), noting that a degree of endorsement is required for conduct to constitute compelled speech.

<sup>33</sup> Google, *An Explanation of our Search Results* (21 March 2007). Accessible at <<http://web.archive.org/web/20070321092528/http://www.google.com/explanation.html>>

<sup>34</sup> [2009] EWHC 1765 (QB)



responsible for the making of the comment.<sup>35</sup> Of course, this comparison is far from perfect. A telephone operator will have virtually no control over the manner in which people communicate over the telephone. Google, on the other hand, does have significant control over how people interact with online content through its search engine. Perhaps a more apt example would be that of a camera manufacturer. Just like the Google algorithm, the hardware of a camera will have a direct impact on what users of that device see (as well as anyone else who views the photograph). Different hardware assortments will result in different images that will capture different impressions. Should someone use this camera in a manner that illustrates another in a poor light (figuratively speaking), the facilitating role that the camera played in creating the image would be insufficient as to expose it to legal liability.

Interestingly, even though Google's role in *Metropolitan International Schools* was deemed not to constitute that of a publisher, the Court implied it was still entitled to a degree of protection under section 12 of the Human Rights Act 1998 (implementing Article 10 of the European Convention on Human Rights). This is because Article 10 pertains not just to a person's right to speak; it also protects the right of third parties to receive that speech.<sup>36</sup> While not expressly elaborated upon, the argument appears to be that since Google plays a vital role in ensuring people can find information online, it enables users to receive speech (published by other websites) online which they would otherwise be oblivious to. It is a shame this point was not expanded upon further as it raises many interesting issues. For instance, if Google's role is to facilitate speech, could it be regarded as a forum? A kind of online *noticeboard*? Even private, nonpublic forums can have a degree of responsibility in relation to not suppressing speech. In *Pruneyard Shopping Center v Robbins*, the US Supreme Court held that the First Amendment extended to protect leaflet distributors even where they distributed in privately owned shopping centres.<sup>37</sup> The Court noted that permitting distributors to do this would not infringe the rights of the shopping centre owners because there was no risk of people thinking the distributors represented the views of the shopping centre. Furthermore, the shopping centre was in a position to erect notices firmly stating they did not endorse the views of anyone circulating leaflets on their grounds. If Google can be seen as a forum (a nonpublic one, clearly), this reasoning would also apply to it. No one is likely to think that the viewpoints contained on a Google-referred website are therefore held by Google or its employees. Similarly, it would be very easy for Google to post a message on its results page making it absolutely clear that it endorses none of the views contained on any linked pages (or "snippets" of those pages).

The practical difficulties in regarding Google as a publisher were also explored by Eady J.. Unlike a standard publisher, Google does not know exactly what information it disseminates until its algorithm processes the specific search query. Its only way of regulating undesirable information is to implement changes to its algorithm so that certain types of websites receive lower ranks or are blocked completely. For instance, Google recently announced an update to its algorithm that is geared

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<sup>35</sup> Matthew Collins, *The Law of Defamation and the Internet* (2nd ed, Oxford University Press, 2005) at 15.38

<sup>36</sup> *Loutchansky v The Times Newspapers Ltd* [2002] QB 783

<sup>37</sup> 447 U.S. 74 (1980)



towards downgrading websites that infringe copyright.<sup>38</sup> It will do this by taking into account the number of valid copyright removal notices that it receives in respect of a given site. Implementing similar filters to provide less visibility for potentially defamatory results would likely cause a mass of genuine results having their rank unfairly lowered. This outcome would be equally inevitable if Google opted for more crude measures such as blocking out specific words. This measure was classified by Eady J. as being both highly ineffective and wholly disproportionate.

### **The E-Commerce Regulations 2002**

Although it would appear that Google cannot be regarded as a publisher for the purpose of mounting a defamation action, this does not mean that defamed businesses are without recourse. The E-Commerce Regulations 2002<sup>39</sup> lay down three classes of “information society services” which have varying levels of responsibility: mere conduits, caching and hosting. Before assessing which class Google falls within, it is necessary to explore the initial requirement: whether Google’s search results can be regarded as an information society service.

“Information society service” is defined in Regulation 2 as having five components. It applies to any service that is (a) normally provided for remuneration, (b) at a distance, (c) by means of electronic equipment, (d) for the processing and storage of data, and (e) at the request of the recipient.<sup>40</sup> Most of these criteria do not require explanation as to how they apply to Google; only the first component raises concerns. It is clear that Google receives remuneration from providing search results, but this remuneration does not come directly from the recipient. Google makes its money from selling advertisement space that appears on the “Sponsored results” section of the results page. The question then is how direct the causal link between the recipient and the remuneration needs to be. Eady J. has described it as a “distortion of language”<sup>41</sup> to regard a service as “for remuneration” just because it eventually results in payment. However, this observation is contradicted by Recital 18 of the Directive, which notes that information society services can “extend to services which are not remunerated by those who receive them”. Notwithstanding any ambiguities in the wording of Recital 17, Recital 18 does make it quite clear that the legislative intent is to include more remotely financed services like search results within the ambit of the Directive rather than only applying to direct contracts for remuneration. It has been suggested that the function of the “for remuneration” requirement is to rule out internal networks run by businesses.<sup>42</sup>

Since we can proceed on the basis that search results are an information society service and therefore governed by the Regulations, the next question is how exactly to classify them. As noted above, there are three classes under the Regulations. Regulation 17 provides the highest level of protection to “mere conduits” but this definition would be inapplicable. One of the requirements of being classed as a mere conduit is that the service does not select or modify information contained in the

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<sup>38</sup> Amit Singhal, “An update to our search algorithms” *Google Inside Search*, 10 August 2012. Accessible at <<http://insidesearch.blogspot.com/2012/08/an-update-to-our-search-algorithms.html>>

<sup>39</sup> SI 2002 No. 2013, implementing the EU Electronic Commerce Directive 2000/31/EC

<sup>40</sup> Definition transcribed from recital 17 of the Directive

<sup>41</sup> *Metropolitan Int. Schools* at para. 82

<sup>42</sup> Patrick Milmo & Ors, *Gatley on Libel and Slander* (11th ed., Sweet & Maxwell 2010) at para. 6.28



transmission. Since the main function of search engines is to select relevant information and return its location to the user, Google could not avail of the heightened immunity provided to conduits. Perhaps the most applicable classification is “caching” as laid out in Regulation 18. This pertains to “automatic, intermediate, and temporary storage” which is for the purpose of efficiently transmitting information to recipients provided that the service doesn’t modify that information. This description seems well tailored to Google’s service. The only potential issue is with regards modification. Google obviously doesn’t modify content in the strict sense of the word, but it might be argued that the choice of content posted in the “snippet” could constitute modification by omitting pertinent facts and thus giving a misleading impression taken in isolation. This logic was seen in *Stoll v Switzerland* where the European Court of Human Rights held that selectively republishing sections of a report so that it gives the wrong overall impression can constitute modifying the meaning of the document and rule out a truth defence.<sup>43</sup> The final category, found in Regulation 19, is “hosting” which would likely to be inapplicable to search results because it places a higher emphasis on the storing of information provided by the recipient.

If the above analysis is correct, and Google’s search results can be regarded as “caching” under Regulation 18, it then has a duty to act expeditiously to remove or disable access to information it has stored once it receives actual notice that the initial source of the information has been removed. The same duty applies where the information’s removal has been ordered by a court or administrative body (even if the initial source hasn’t been removed). While this would enable businesses to have damaging websites removed from Google’s caches, it only does so once the website itself has been removed or its removal ordered. This may provide some comfort by ensuring that defamatory comments can’t be accessed perpetually through Google’s cache, but ultimately the level of assistance it provides for businesses is very narrow. It essentially requires businesses to take down (either through persuasion or litigation) the contentious website itself before Google can be compelled to remove it from search results. This is more akin to a clean-up mechanism than it is to a substantive cause of action. Also, it would be of no assistance in instances where there is no defamatory content, but the highest-ranking searches provide a misleading impression. Consider the McDonald’s example given at the start of this section; by allowing a very critical documentary to appear at the top of Google searches, it is giving the impression that the most important information pertaining to McDonald’s is of a uniformly negative nature. Given the ease of which search engines can influence opinions and positions,<sup>44</sup> the result could be a public relations disaster for the company. Despite this, there would be virtually no recourse. The documentary in question isn’t defamatory, so there would be no scope for having it removed. It could be argued that by giving it an unduly visible *PageRank*, Google is creating a misleading impression as to that information’s salience. Any such argument, however, would not be reflected by either the E-Commerce Regulations or the current UK law of defamation.

## **Part II - Autocomplete**

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<sup>43</sup> App no.69698/01 (10 December 2007)

<sup>44</sup> Nekon Elkin-Koren, “Let the Crawlers Crawl: on Virtual Gatekeepers and the Right to Exclude Indexing” (2000) 26 *University of Dayton Law Review* 179 at 185-186



It is not just the results themselves that pose risks; Google can cause reputational damage before the “Google Search” button is even clicked. Google’s *Autocomplete* feature displays commonly searched phrases while a user is typing his request into the search bar. Save for filtering a narrow set of subjects (e.g. pornography, hate speech), Google’s algorithm will reflect what is most frequently searched for by the totality of web users.<sup>45</sup> Other criteria will also be factored into the ranking, such as relevance and the degree of “freshness” (i.e. whether a search has received a sudden surge in popularity).<sup>46</sup> While this feature is undoubtedly useful, it permits the displaying of defamatory insinuations next to a company’s name. In 2011, the owners of an Irish hotel brought an action against Google in Ireland’s High Court because the word “receivership” appeared in *Autocomplete* when a user *Googled* the hotel’s name.<sup>47</sup> This grievance is not difficult to understand. It means that before a user even sees the search results, they will already be given the impression that the hotel is in a precarious financial state. This concern would be particularly pressing if it related to a company that was publicly traded; as it could deter potential investors as well as potential guests. Unfortunately, from an academic perspective, the case settled before the Court could make a ruling.<sup>48</sup>

The available rulings in the EU on the subject of *Autocomplete* defamation indicates a judicial willingness to safeguard reputation at the expense of Google’s freedom to disseminate information. While there has yet to be a reported decision pertaining to corporate reputation, the issue of personal reputation has been litigated on two occasions. In 2010, the Superior Court of Paris found Google to be liable when a search of the plaintiff’s name suggested a list of phrases linking him to rape and Satanism.<sup>49</sup> The Court noted that associating these terms with the plaintiff’s name amounted to the public slander of a private individual. A similar result was reached in Italy the following year, where the Court of Milan ordered Google to filter out defamatory material in relation to an individual whose name conjured the suggestion of “*truffatore*” (meaning “fraud”).<sup>50</sup> It is regrettable that in both of these cases, the Court did not engage in a detailed analysis of the legal classification of *Autocomplete*, instead simply focusing on the damage done to the plaintiffs. This section will attempt to provide that analysis.

At first glance, one might question why *Autocomplete* should be treated differently to search results. The previous section of this paper has put forward the argument that Google isn’t a “publisher” of search results from a defamation perspective, so why should its role in relation to *Autocomplete* be any different? The answer is that there are two notable distinctions between how the two services operate, which might give rise to a contrary classification. The first reason is that, in the case of *Autocomplete*, Google has an active role in the creation of the content. While a search result will merely display URL’s of websites that existed previously, *Autocomplete* constitutes a medium through which the suggestions are authored. In this regard, its role is more akin to that of a message board. It

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<sup>45</sup> <<http://support.google.com/websearch/bin/answer.py?hl=en&answer=106230>>

<sup>46</sup> Danny Sullivan, “How Google’s Autocomplete Suggestions Work” *Search Engine Land*, 6 April 2011 <<http://searchengineland.com/how-google-instant-autocomplete-suggestions-work-62592>>

<sup>47</sup> Mary Carolan, “Hotel sues Google over search result” *The Irish Times*, 8 November 2011

<sup>48</sup> Mary Carolan, “Louth hotel settles case with Google” *The Irish Times*, 22 November 2011

<sup>49</sup> Andrew Hough, “Google convicted of defaming French user by ‘linking his name to rape in searches’” *The Telegraph*, 27 September 2010

<sup>50</sup> David Meyer, “Google loses defamation case in Italy” *CNET News*, 5 April 2011





enables users to compose phrases, which are hosted by the website and displayed for other users to see. Secondly, Google is far more heavily involved in actively blocking results from its *Autocomplete* suggestions than it is for its search results. As previously discussed, Google doesn't engage in blocking certain words from appearing in its search results. It does, however, block specifically identified words from returning *Autocomplete* suggestions. Suggestions relating to "*BitTorrent*" and "*RapidShare*" are removed from search suggestions;<sup>51</sup> a move taken voluntarily by Google.<sup>52</sup> Since the lack of control that Google has over the search result content it displays was a key factor in the Google-friendly *International Metropolitan Schools* decision, it could be argued that its heightened policing function regarding *Autocomplete* could bring it within the ambit of "publisher".

### **Google's role in composing and storing suggestions**

Since the suggestions provided by *Autocomplete* are created on Google, stored by Google, and ultimately viewed by the recipient on Google, it should be safe to assume that Google is the medium through which this content is received. This is distinct from search results, where none of the content is created by Google, merely indexed by it. This could mean the courts would take a broader view of Google's role in the creation of *Autocomplete* phrases. Unlike a defamatory search result, there is no other party that a company could target to ensure the defamatory content is removed. As we have seen, the E-Commerce Regulations put the initial responsibility for unlawful content on the heads of the website that hosts it. It is only after a company has the hosting website taken down, that they may compel Google to remove it from its cache. With regards *Autocomplete*, there is no other site that could be regarded as responsible for the content or capable of taking it down. Thus, Google is essentially hosting user-generated content in much the same way as the "comments" section of a website.

The UK case law on the classification of hosting websites has been contradictory. In *Davidson v Habeeb*, Parkes QC (sitting as a judge of the High Court) based his ruling on the original UK position that would impart liability on hosts that had actual knowledge of defamatory content.<sup>53</sup> He held that Google could be regarded as a publisher of content posted on its *Blogger.com* website provided it receives express notification of that content's defamatory nature.<sup>54</sup> The judge analogised *Blogger* to a giant *noticeboard*, noting that it would be unrealistic to assume the owner has knowledge of everything posted on it. But once Google has been notified of a comment on that board, it can be regarded as having consented to the publication. This analogy makes good sense and would have provided a sensible rule regarding host liability. Just like the metaphorical *noticeboard* owner, Google knows that the service it provides might be used for unlawful expression and it has the power to remove such expression from the board. Placing liability on Google where it fails to remove hosted unlawful user-generated content strikes a fair balance between Google's ability to effectively run its business and the interests of those who might suffer reputational damage as a consequence.

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<sup>51</sup> "Google starts censoring BitTorrent, RapidShare and more" *Torrent Freak*, 26 January 2011. Accessible at <http://torrentfreak.com/google-starts-censoring-bittorrent-rapidshare-and-more-110126/>

<sup>52</sup> Although a recent French decision has indicated that courts may order Google to block certain terms. [http://news.cnet.com/8301-1023\\_3-57475366-93/google-must-delete-torrent-from-autocomplete-court-says/](http://news.cnet.com/8301-1023_3-57475366-93/google-must-delete-torrent-from-autocomplete-court-says/)

<sup>53</sup> *Godfrey v Demon Internet Ltd* [2001] QB 201, which involved a defamatory message in a Usenet discussion group.

<sup>54</sup> [2011] EWHC 3031 (QB)



Despite its good sense, the applicability of *Davidson* has been curtailed by the subsequent decision in *Tamiz v Google*.<sup>55</sup> A similar issue arose in this case: an individual was allegedly defamed in a post on Blogger and brought an action against Google as a result. The case was decided by Eady J. and, just like in *Metropolitan International Schools*, the result was very pro-Google. Not satisfied with the reasonable analogy provided by Parkes QC, Eady J. likened Blogger to a wall that was owned by Google. He opined that it was not Google's responsibility if some vandal came along and spray-painted defamatory graffiti on that wall. While analogies can be helpful in the transposition of common law principles to new technologies, they run the risk of misstating the nature of that technology, as is the case here. A person who erects a wall does not do so for the promotion of expression or dissemination of information. Nor does he make any money from content placed on his wall. An internet host, on the other hand, provides storage for the express purpose of facilitation of speech and information; and receives remuneration as a result (albeit indirectly). Their role in the process then is hardly as uninvolved as the hypothetical oblivious wall owner proposed by Eady J.. The main distinction between the approach set out here and that in *Davidson*, is that under the ratio laid down by Eady J., a host is not a publisher even if it has received actual notification of the defamatory comment. The only course of action for a defamed company is then to target the actual author of the content. While this can be difficult enough when it relates to standard hosting (bloggers can write under false names and use proxies to block their IP address), it is virtually impossible when applied to *Autocomplete*. Even if an individual search request is capable of being defamatory (which is doubtful considering it is more akin to a question than a statement), there is no way a user can delete their search request from Google in the same way an author can delete a comment they posted on Blogger.

### **Blocking suggestions**

In *Metropolitan International Schools*, Eady J. noted that requiring Google to block out defamatory search results would likely rule out a large amount of lawful content, as well as being ineffective at properly removing the content which was actually complained of. Even if the original source of the content can be blocked, the author could easily publish the same content to a different website in order to get around the block.<sup>56</sup> This concern isn't as applicable in the case of *Autocomplete*. Unlike search results, in which the algorithm is based on substantive attributes of websites (such as number of views and referrals), *Autocomplete* is based on the content of the search request and how frequently and recently it has been entered. Certain words can be blocked from suggestions without fear that they will have a prominent knock-on effect on valid content. Blocking the word "receivership" from appearing beside a specific company's name would constitute quite a narrowly curtailed measure of information suppression; far narrower than blocking specific websites from search results. The effect would also be preferable in that it would target specific phrases as opposed to specific sites. So, rather than blocking a website, which could be regarded as limiting that website's right to disseminate information, it would merely block a specific phrase from being suggested. There is a further distinction in that posts on websites are usually geared towards expressing a certain

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<sup>55</sup> [2012] EWHC 449 (QB)

<sup>56</sup> *Metropolitan Int. Schools* at para 62



opinion or revealing certain information. The same cannot be said for search results; which are essentially just requests for information rather than being information themselves.

From a First Amendment perspective, the distinction between search results and search suggestions could amount to the difference between a content-neutral restriction on speech and a content-based restriction. It has been consistently held that if a restriction on speech is directed at specific content, its First Amendment protection is lowered.<sup>57</sup> The test preferred by the Supreme Court is whether the restriction can be justified without reference to the content of the speech.<sup>58</sup> If a search result is to be regarded as speech, downgrading specific websites based on an objective criteria would likely be viewed as a content-neutral restriction. Websites are not typically given a low rank because they have disagreeable content. The same cannot be said in relation to search suggestions. By blocking suggestions containing "*BitTorrent*" and "*RapidShare*", Google are restricting traffic to websites that carry this specific content (in that they are removing suggestions which could lead to those websites) because they find it disagreeable. The ease at which Google can block content from appearing in suggestions as well as the willingness they have already displayed in doing so, both contrast with the level of objectivity they have been accredited with in relation to their results. By choosing which specific content to omit, Google could be regarded as choosing to publish everything else. A content-based classification will not result in Google's *Autocomplete* losing protection *per se*,<sup>59</sup> but it will provide another obstacle in attempting to establish itself as a neutral *facilitatory* platform, as opposed to a publisher of defamatory content.

### **The E-Commerce Regulations 2002**

The analysis in Part I shows that the classification of search results as an "information society service" isn't particularly problematic. In the case of *Autocomplete*, however, classification becomes more complicated. The two prongs of the 5-stage test that present us with difficulty on this occasion are (a) that the service be for remuneration, and (d) that the service be at the request of the recipient.

We saw previously that the indirect nature of Google's remuneration (it comes from advertisers as opposed to coming from the recipients directly) shouldn't act as a bar to its classification as an "information society service". With *Autocomplete*, it could be questioned whether it is for remuneration at all. There are no advertisements displayed on the Google homepage where the search suggestions appear (or on the Google toolbar found on some browsers). Ultimately the classification will likely depend upon whether *Autocomplete* can be regarded as a separate service in and of itself or an integral feature of Google search. If it is the former, it would clearly not be for remuneration as there is currently no mechanism for monetising it. The latter argument is perhaps more likely since it is so tightly entwined within Google's search service. It might be that *Autocomplete* is deemed a feature of Google search, and its monetisation can be regarded as increasing the number of users who choose Google as their preferred search engine. There are many

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<sup>57</sup> *United States v O'Brien*, 391 U.S. 367 (1968)

<sup>58</sup> *Ward v Rock Against Racism*, 491 U.S. 781 (1989)

<sup>59</sup> See *R.A.V. v City of St. Paul*, 505 U.S. 377 (1992) noting that content restrictions aren't automatically deprived of First Amendment protection, but they are more difficult to justify (at 387).



features unique to Google that don't directly pertain to the quality of results, but which still might sway users to choose Google over other search engines (e.g. Google Instant, Safe Search, Knowledge Graph). None of these provide a direct stream of income but their overall effect of improving the quality of Google search likely leads to higher income by increasing the number of people using the service and clicking on sponsored results. If *Autocomplete* can be classified in a similar manner, the remuneration requirement should be satisfied.

A similar concern is raised when considering whether *Autocomplete* constitutes a service that is "at the request of the recipient". Since search suggestions appear automatically as a user starts typing, it seems strange to class them as being at the recipient's request. From a linguistic perspective, a "request" should involve a deliberate submission of data (e.g. clicking "Google Search"), as opposed to something that happens automatically. The Commission, however, has taken a much more expansive view of the definition of request. The requirement has been elaborated upon as "requiring the element of interactivity which characterises information society services and sets them apart from other services that are sent without a request from the recipient being necessary."<sup>60</sup> This test presents a somewhat different requirement to that laid down in the Directive. The focus on interactivity as opposed to a conscious act of requesting would bode well for the inclusion of search suggestions. Since there can be little denying that *Autocomplete* is an interactive service, its satisfaction of this prong of the test seems almost certain.

Supposing that *Autocomplete* is "for remuneration", then it will surely be classified as an "information society service". In order to determine what duties attach to it under the Regulations, a further classification is necessary. While it has been suggested that search results should be classed as "caching" under Regulation 18, search suggestions would best be classified as "hosting" under Regulation 19. This is because search suggestions do entail "storage of information provided by the recipient of the service". To fall within the definition of "caching", the level of storage would have to be "automatic, intermediate and temporary", which wouldn't pertain to *Autocomplete's* practice of storing data on searches made so that they can be reproduced when another user has a similar query. Given that the "hosting" classification involves a higher level of storage, it also comes with more onerous responsibilities. Under Regulation 19(a)(i), once the provider receives notification of any unlawful content it stores, it has an obligation to remove that content. This goes over and above the rather limited duty of "caching" services to disable access once a website is removed. The result is a fair balance between Google's right to disseminate information through suggestions (as well as the user's right to receive such suggestions) and the rights of companies who are defamed through disparaging search suggestions. While companies may face difficulty in showing that a certain suggestion is defamatory, at least it can be spared the jurisdictional headache of taking down the website that is the original source of the defamation.

## **Conclusion**

In the case of search results, companies who suffer reputational harm through low rankings of their website or high rankings of defamatory websites on Google are virtually without recourse. From a

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<sup>60</sup> "A coherent framework to boost confidence in the Digital Single Market of e-commerce and other online services" *EU Commission Communication*, 11 January 2012, at 9



legal perspective, Google cannot be regarded as a “publisher” for the purposes of the Defamation Act 1996. This is because Google has no substantial role in the creation of the content that appears within its search results. Any claim that the index of results themselves constitute an instance of “speaking” is invalidated by the absence of any message to be found within the results. The decision in *Metropolitan International Schools* in England will make it very difficult for a company to bring a defamation case against Google in the foreseeable future. The only recourse available is found in the E-Commerce Regulations; which will be of little comfort. Since Google can be regarded as a “caching” service, it means that a notification of unlawful conduct will be insufficient to compel Google to disable access to a defamatory website. The company will instead have to take action against the source website itself, which may present difficult jurisdictional issues as well as leaving the author open to simply republishing the message on another website.

With regards to *Autocomplete*, the law should provide a greater degree of protection. The prospect of proving Google as a publisher seems more likely considering how easily Google can block out specific content. The fact that Google has already engaged in this blocking could be regarded as a content-based restriction on speech which would further invalidate any First Amendment or Article 10 defence it might raise. Google’s role in the creation of the content would bring it closer to the definition of a hosting website than a mere facilitator. Under this view, Google should be regarded as a publisher for defamatory content it has been notified of. However, the decision in *Tamiz v Google* undermines this argument and establishes the undesirable situation where Google can escape publisher liability for search suggestions in the same way it does for search results. This position serves to overlook the distinctions between the two features. It also ignores the distinction laid out in the E-Commerce Regulations that separates caching services and hosting services. Given how Google stores the actual content of search suggestions, *Autocomplete* should be regarded as the latter, which would afford companies a degree of protection in compelling Google to remove defamatory suggestions. The applicability of this protection can be called into question in light of the decision in *Tamiz* however. The overall position is one that puts Google beyond regulation and companies without recourse for damage to their reputation.