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ARTICLES AND ESSAYS

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Brazilian Administrative Council for Economic Defense: An Approach from Sociology and History

MARCO ANTONIO LOSCHIAVO LEME DE BARROS †

TABLE OF CONTENTS: 1. Introduction; 2. Sociological and Historical Framework to Analyze Legal and Economic Institutions; 2.1. The Pendulum Between Market and Government; 2.2. The Institutional History and Sociology Standpoint of View; 3. CADE's Institutional History; 3.1. The Beginning of the Economic Competition Protection; 3.2. The Defense of Popular Economy; 3.3. The Consolidation of the SBDC; 3.4. CADE as an Administrative Court; 3.5. The New CADE; 4. Final Remarks.

ABSTRACT: This paper is a sociological and historical analysis of the Brazilian Administrative Council for Economic Defense - C.A.D.E. The main objective is to indicate that C.A.D.E. has become a reference for the development of the Brazilian System of Competition Defense due to institutional factors. I argue that a fundamental process of strengthening C.A.D.E.'s power was the institutional learning process incorporated at the structural level, which allowed the agency the ability to review its positions and constantly rebuild its structures and functions during different moments in Brazilian antitrust history. Besides the institutional learning, C.A.D.E. was also subject to different institutional influences over the past decades. A decisive moment was the 1990s when a national privatization program was carried out and the competitive protection system was articulated with regulated sectors and policies in Brazil. An important framework to understand these transformations are the systemic sociology of organizations and legal developmentalist literature. Both approaches – with different backgrounds – help to clarify that many institutions are derivative from previous ones, and that they are also embedded in certain operations related with society. In C.A.D.E.'s case, Brazil's judiciary and executive branch played an important role in shaping the agency divisions and functions. The paper underscores four different moments of the agency: the Malaia law C.A.D.E.; the 1962 C.A.D.E. – a collegiate agency of the ministry of justice; the 1994 C.A.D.E. – an autonomous federal agency – and the new C.A.D.E. per the Antitrust Act. Finally, C.A.D.E.'s case confirms that the existence of previous institutions has become an indispensable assumption for their development in light of a continuous institutional learning process.

KEYWORDS: *Brazilian Administrative Council for Economic Defense/C.A.D.E.; Development; Institucional Learning; Institutional Influence; History; Competition.*

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1. INTRODUCTION

The Brazilian Administrative Council for Economic Defense (Conselho Administrativo de Defesa Econômica - hereinafter C.A.D.E.) is an "administrative court" established in 1962 as an agency of the Ministry of Justice and transformed in 1994 into an autonomous federal agency. Its new attributions as an adjudicatory court were established by the enactment of Act No. 12.529/11,[1] also referred to as Brazil's new Antitrust Act. Among its functions, C.A.D.E. is the agency responsible for administrative trials of infringements against economic order and merger review, by means of the so-called acts of concentration.

Despite considering all its preventive and repressive functions, the most significant role played by C.A.D.E. is the implementation of a policy and a structure to defend economic competition in Brazil. In this sense, Luiz Carlos Delorme Prado, former C.A.D.E.'s Commissioner confirms that "the consolidation of the Brazilian system for the defense of competition, which culminated in the enactment of Act No. 12.529/11, must be seen as the result of a historical process going back to the 1930s."[2]

The purpose of this text, based on a historical analysis, is to indicate that the consolidation of the system for defense of competition did not take place as a process of simple legal transplant and endowment of factors from foreign experiences. C.A.D.E.'s history underscore a trajectory of successes and failures of models and interests in a complex relationship between market, law and government economic program in Brazil.

Beyond the argument that "institutions matter," the theoretical framework for this analysis is inspired by the systemic sociology of

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[1] Decreto No. 12.529, de 3 de Novembro de 2011, DIARIO OFICIAL DA UNIAO [D.O.U.] de 1.12.2011 (Braz.).

[2] LAERCIO FARINA ET AL., A NOVA LEI DO CADE 99 (2012).

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organizations[3] and works of legal developmentalist scholars[4] that affirms that institutions are "embedded" and, thus, their functions depend on the previous existence and relations with other institutions (institutional influence) and also on internal structures that permit institutions to review and amplify their actions (institutional learning).

From a systemic point of view, it is important to understand that institutions are "embedded" because they can be observed as functionally differentiated social systems. Institutions are differentiated from their environment or, like pointed out by the main social system theorist Niklas Luhmann, institutions acknowledge as their own only communications between members, and only when they communicate as members.[5]

However, paradoxically, all institutions operate simultaneously within a given environment, thus this observation is also about a dynamic process of constant reconstruction of the institution operations (structures and programs) in relation with their environment (other systems). Institutions stimulate their growth reciprocally, by arranging businesses for mutual relations or by establishing common facilities that must be supported by both parties.

In this sense, it is not possible to deny the histories of institutions or, as theoretical institutionalists argue, the importance to understand their continuities. Institutions are designed to succeed and to be preservative, but given uncertainty about future, usually manipulation and failures happen and it is not always possible to overturn constraints.

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[3] By systemic organization sociology we mean any kind of development of Luhmann's sociological theory of organizations. An important example is the work of Dirk Baecker. For a full comprehension of systemic organization sociology see the special issue on Niklas Luhmann and Organization Studies on the *Journal Organization*: David Seidl & Kai Helge Becker, Organizations *as Distinction Generating and Processing Systems: Niklas Luhmann's Contribution to Organization Studies*, 13 ORGANIZATION J. 9 (2006) and STEFAN KÜHL, ORGANIZATIONS: A SYSTEM APPROACH (2013). For a general account about legal institutions from a sociological perspective in Brazil see CELSO CAMPILONGO, POLÍTICA, SISTEMA JURÍDICO E DECISÃO JUDICIAL ([*Politics, Juridical System and Judicial Decision*] (2nd ed., 2011).

[4] Legal devolpmentalists scholars is a general term that refer to legal sociologists that considerer in their analysis an embedded approach towards law and society. For this paper, we classify the works of Alice Amsden, Peter Evans, Katharina Pistor, Curtis Milhaupt and Charles Sabel as legal developmentalists.

[5] In this perspective, an institution functions consists of recursively operations of decisions – understood as communication of choice attribution between alternatives and nothing else -, that they generate only own their sequent operations. *See* NIKLAS LUHMANN, ORGANIZACIÓN Y DECISIÓN, AUTOPOIESIS, ACCIÓN Y ENTENDIMIENTO COMUNICATIVO (2005).

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This description can be translated into straightforward concepts of institutional influences and institutional learning, especially carried out by a legal developmentalist literature based on the dynamics of learning processes, specifically "the learning centered approach to development" of Charles Sabel and Sanjay Reddy.[6] In this framework, it is highlighted how institutional modifications can occur by focusing on the influences and the learning process in their internal structures.

This paper presents an institutional case study of C.A.D.E. By institutional case study, I mean the sociological and historical approach about the transformations of structures and operations of certain institutions. I argue that C.A.D.E. together with the Secretariat of Economic Monitoring (Secretaria de Acompanhamento Econômico - S.E.A.E.) has been a leader in a "constellation" of legal and extralegal norms in Brazil[7] that plays a symbolic role in implementing the Brazilian System for Competition Defense (Sistema Brasileiro de Defesa da Concorrência - hereinafter S.B.D.C.). The paper is organized into four parts. Part II recalls the pendulum argument between the market and government to explain the sociological and historical framework regarding organizations. After understanding the key concept of embeddedness, presupposed in the pendulum case, the paper argues the importance of analyzing the institutional influences and the institutional learning process that permits to describe the complexity of institutions in modern societies. Part III details C.A.D.E.'s trajectory regarding the history of the antitrust in Brazil in four different moments from the early Republic period until the 2010s. In each moment, the decisive factors for the creation and development of C.A.D.E. are highlighted, with special consideration to the 1990s that represented the modernization of the executive branch, that evolved different administrative reforms and regulation of certain sectors. Part IV

[6] *See* Charles Sabel and Sanjay Reddy, *Learning to Learn: Undoing the Gordian Knot of Development Today*, 50 CHALLENGE NO. 5, 2003, at 73-92.

[7] The notion of constellation of legal and extralegal norms results from the finding of various centers of normative production as pointed out by the Brazilian legal sociologist José Eduardo Faria. As a matter of fact, the government intervention in the economy occurs in a fragmentary form in Brazil with the participation of other the Regulatory Agencies, Securities and Exchange Commission of Brazil (*Comissão de Valores Mobiliários*), Central Bank of Brazil (*Banco Central*), public agencies, public policies for the development of sectors of economic activity (civil construction, technologies, and others). *See* JOSÉ EDUARDO FARIA, A SOCIOLOGIA JURÌDICA: DIREITO E CONJUNTURA [*Juridical Sociology: Law and Contingency*] (2008)

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presents some final remarks that confirms the prominent position of C.A.D.E. in Brazil.

2. SOCIOLOGICAL AND HISTORICAL FRAMEWORK TO ANALYZE LEGAL AND ECONOMIC INSTITUTIONS

The study of legal and economic institutions has seen incredible growth in recent decades, however there is still little agreement about how to analyze them. A range of views about how to approach these institutions also reveal different perspectives about what an institution is and how they should operate in society.

Should we approach legal and economic institutions from the standpoint of rational-choice that considers them as a system of rules and incentives, thus centering thinking around finding an optimal design?[8] Or should we emphasize more on path dependence, as pointed to by historical institutionalism, that seeks to understand their continuities and failures?[9] We can also follow a sociological approach that reminds us that institutions are autonomous structures and programs from actors, that operate with internal norms and culture that continuously regenerate them across time.[10]

These cases provide us a starting point to understand the importance of the debate about institutionalism—differing frameworks to analyze institutions.[11] A very common approach also deals with the global perspective vis-à-vis particularism about institutions. This opposition reveals a complementary view about how the big picture of world society and evidence of particularities of local practices are entangled with one another.

[8] *See* Barry Weingast, *Rational choice institutionalism*, *in* POLITICAL SCIENCE: THE STATE OF THE DISCIPLINE 660 (Ira Katznelson & Helen V. Milner eds., 2002).
[9] *See* Elizabeth Sanders, *Historical institutionalism*, *in* THE OXFORD HANDBOOK OF POLITICAL INSTITUTIONS (Roderick Rhodes, Sarah Binder & Bert A. Rockman eds., 2006).
[10] Sociological institutionalism is related in this paper with the systemic organization sociology, see *supra* note 3
[11] *See* for a general account about institutionalism THE OXFORD HANDBOOK OF POLITICAL INSTITUTIONS (Roderick A. W. Rhodes, Sarah A. Binder & Bert A. Rockman eds., 2006).

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We know that many institutional dynamics do not stop at national borders and that at the global level there are many struggles and disputes about which and how institutions should prevail and operate. Many economists, politicians and lawyers mention this by explaining the emergence of transnational legal regimes and the global rule by expertise. Transnationalism and rule by experts are characterized by large asymmetries and, thus, economic and political crises are byproducts – or even intended consequences – created by different intuitions in an uncertain world society, defined by sociologist Fischer-Lescano and Möller as "a society both without a head and without a center."[12]

Despite this broader perspective that can be historically explained by the oscillation of the pendulum between market and government in a global governance context, I argue that the study of institutions should also focus local practices, that can also reveal several asymmetries and entanglements. In this sense, this paper follows a historical and sociological framework to understand the particularities of C.A.D.E.'s transformation. First, I address the global picture about the development agenda to briefly discuss the relation between market, government and law. Finally, I discuss the historical and sociological framework mobilized in part III.

2.1. THE PENDULUM BETWEEN MARKET AND GOVERNMENT

One of the main topics that are still debated by scholars interested in the development agenda is the problem of emerging economies, or the economies of the "rest."[13] The main question in these cases is to know why the development race is an unequal process? Regarding this problem, it is necessary to explain how some "backward" economies managed to develop during the second half of the twentieth century, above all surpassing the traditional mold of labor division and maximization of production, while remaining strong with competitive markets at the beginning of the twenty-first century.

[12] *See* TRANSNATIONALISATION OF SOCIAL RIGHTS 16 (Andreas Fischer-Lescano and Kolja Möller eds., 2016).
[13] *See* ALICE H. AMSDEN, THE RISE OF THE REST - CHALLENGES TO THE WEST FROM LATE-INDUSTRIALIZING ECONOMIES (2001).

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The Neo-institutionalist literature,[14] strongly influenced by the formal weberian matrix,[15] articulates this problem highlighting the importance of strengthening the institutions. In this perspective, the development race was an unequal process because many economies did not undergo the "revolution of capitalism"— i.e., did not cope with a necessary step for a well-functioning market system and the establishment of a rational model of law.

The rational model can be explained as an endowment of certain factors that were transplantable just like an equation between "good law" and "good application" able to produce "good economic results." In this perspective, economic activities occur in an institutionalized and organized environment and the market is not only the result of interactions among rational agents, but also among the rules.[16] Therefore, law would have to be considered a regulatory instrument to exert and legitimate power while also being an effective mechanism to protect property in any economic structure.[17]

Historically, this can be exemplified by the efforts of the United States to promote policy changes in Latin America through legal reform, like those

[14] The Neo-institucionalist (or the New Institutional Economy) says that the problem of development is not the formation of capital, but the allocation of resources itself in the market, considering the cost of transaction. In this line, with the due specificity of each author, there are outstanding works by Ronald Cose, Oliver Williamson and Douglass North. They are considered new in opposition to the old institutionalist theories, especially those of John R. Commons and Thorstein Veblen.

[15] Max Weber was one of the first sociologist to say that law matters to capitalism, considering the rise of industrial Capitalism in nineteenth century Europe. Based on his historical investigation and analysis of ideal types he found that law, with a high degree of differentiation and substantial trust in general and pre-existing rules (Rational and Formal Law), contributes to the development of capitalism, insofar as it assures a high degree of calculability and the capacity to develop substantive provisions to adjust to the need for market operation. In this sense, legal scholar David Trubek says that the appropriate model for the market system to function is based on legalism, since it is the only means that can provide the necessary degree of certainty to meet the demands of the market, with general and universal rules. See David Trubek, *Max Weber on Law and the Rise of Capitalism,* 1972 WIS. L. REV. 720 (1972).

[16] *See* DOUGLASS NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE (1990).

[17] It would be important to discuss optimal designs and institutional arrangements to meet the specific needs of market operations, of strategic allocations of resources and to stimulate economic growth. For the present study what matters is to point out a few inefficiencies that could be diluted and resolved by the institutional arrangements. Market inefficiency could be determined from the result of a number of controllable and non-controllable factors. Thus, for instance, the following inefficiencies would be highlighted: (i) productive, when production does not occur at the least cost; (ii) dynamic, when an insufficient amount of resources is spent in seeking innovations of products and processes; finally, (iii) allocative, observed when the different goods and services are not produced and consumed in optimal quantities. In all these failures offered, according to the neo Institutionalist authors, it would be possible to recognize optimal institutional models that could mitigate or prevent failures, as, for instance, institutional means to reinforce the competitive pressure among the producers for a better technical development of production, or to implement programs of incentives and innovation processes.

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carried out by the Law and Development movement in the 1960s and 1970s endorsing the necessity of transplanting some successful design models. This movement had a second come back in late 1980s and 1990s focusing on the judiciary reform and regulatory law by arguing that common law institutions are better at fostering economic development.

However, history confirms that the Neo-institutionalist recipe and the Law and Development program did not fully thrive. Despite the outbreak of liberalization and privatizations during the 1900s, under the influence of the Washington Consensus, historical evidence shows that the industrialization process was not hegemonic and was not exclusively the result of rational models of law. On the contrary, there were great variations among countries and the passage from agriculture-based production to the constitution and implementation of an industrial policy is still underway in many developed countries and is regulated by soft law.

Hence, the question "Why was the development race an unequal process?" cannot be considered only as a matter of a top-down assimilation of certain structures from other countries or experiences. Institutions are subject to different empirical variations and path dependences.[18] Society, politics, law and economy operates in different forms, and even transcend state boundaries, and this cannot be ignored or naively rejected in any developmental perspective.[19]

What must be considered is that development is neither a progressive process nor transferable. There are several factors that make economic development a complex phenomenon around the world. Variations can deal with the problems of asymmetric distributions of information, difficulties in coordinating markets, besides, obviously, the very question of accumulation of

[18] North, *supra* note 11, at 115.

[19] Legal scholar Jorge Esquirol illustrate for instance the Latin America case with examples of *acquis légaux* – community gains - where rising social demands have challenged the orthodox formulas, he suggests the cases of the development of labor law, social function doctrine and the constitutionalization of socio and economic rights. *See* Jorge Esquirol, *The Failed Law of Latin America*, 56 AM J. COMP. L. 75 (2008).

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capital and political and cultural influences are fundamental to deal with this issues.[20]

The fact is that in many cases the answers to development problems are not formal solutions, but substantive and conceptual ones. These are issues involving the scope of regulation and allocation of resources in different sectors, the constitution of discretionary spaces for decision-making or even about the history and practices of institutions in society.

In this sense, a more sensible and accurate description about the development can be identified with an analysis that seeks an integrated perspective as a comprehension of the complexities of modern societies. This paper mentions two different approaches that can be correlated in the sense that both are descriptions about contingent distinctions of society and labels that institutions must be understood in context. We can mention the systemic sociology of organizations[21] and the legal developmentalist scholars.[22]

The systemic sociology of organizations can be said to be inspired in the social system theories, a theoretical approach that emphasizes the observations of differences of societies seen as constructed distinctions just as presented by German sociologist Niklas Luhmann. In this perspective, the idea of system is observed as a distinction between an environment and marked by certain operation that is also integrated into internal structures of the system.

What is important to highlight in Luhmann's view is that systems are unable to transcend their own boundaries that are marked by their operations. There is an "embedded" issue – or technically, an autopoietic operation of the system - that must be considered, since each operation of a system produces this boundary by embedding itself in a network of further operations, within which it gains its own unity-identity. For Luhmann's sociology the identity of the system is the marked side of a difference in relation to society, the unmarked side. This approach allows to reflect simultaneously the paradoxes of the marked and unmarked side, since the same is different. Thus, a systemic description of organizations understands institutions as organizational social

[20] *See* Brian Tamanaha, *The Primacy of Society and the Failures of Law and Development*, 44 CORNELL INT'L L. J. 209 (2011).
[21] *See supra* note 3.
[22] *See supra* note 4.

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systems that are embedded in their own operations, most of the time collective decisions, and at the same time differentiates from society as enviroment.[23]

Nevertheless, the embedded argument also appears in another debate of legal developmentalist scholars that discusses the role of the government as the main articulator of development strategies in society. In this perspective, rational law no longer plays a formal role, but provides a structure that can have multiple functions. Legal developmentalists argue that what is important is to recognize the dynamic process between the different relations established between law and society.[24]

What underlies both approaches is the importance of the "embedded" perspective towards institutions. The embeddedness argument had its origins with the economist Karl Polanyi and underscores in social science how institutions cannot be understood disassociated from society. The pendulum argument clarifies the issue, since it is possible to reconstruct the relations between market and government according to a given movement and via law/regulation performance.

The pendulum can reach its maximum point at one extreme and that means that market mechanisms can prove to be insufficient to stimulate economic development. Then the pendulum begins to swing to the other side, once again seeking the intervention of the government as a way of correcting the market failures. However, as soon as the pendulum reaches its maximum point, the government will also present failures.[25]

In addition, the analysis of the balance between market and government often remains superficial if we do not actually account for the disputes and struggles in the global governance context. It is also necessary to reveal the underlying structures and practices that are shaping this swing, usually explained by the rise of a technocratic management. This was pointed

[23] Luhmann, *supra* note 6.

[24] Katharina Pistor and Curtis Milhaupt, for instance, say there is a dynamic relationship as a two–way lane - *rolling relation* – between law and economy. It is a game of back and forth between the market and the law, in a relation to resolve the problems of the markets and successively new legal and extralegal configurations come out. In this dynamic, there are multiple functions of the law, such as coordination, regulation and signaling the new demands. *See* CURTIS J. MILHAUPT & KATHARINA PISTOR, LAW & CAPITALISM: WHAT CORPORATE CRISES REVEAL ABOUT LEGAL SYSTEMS AND ECONOMIC DEVELOPMENT AROUND THE WORLD (reprt. ed. 2010).

[25] *See* PAUL DE GRAUWE, THE LIMITS OF THE MARKET: THE PENDULUM BETWEEN MARKET AND STATE (2017).

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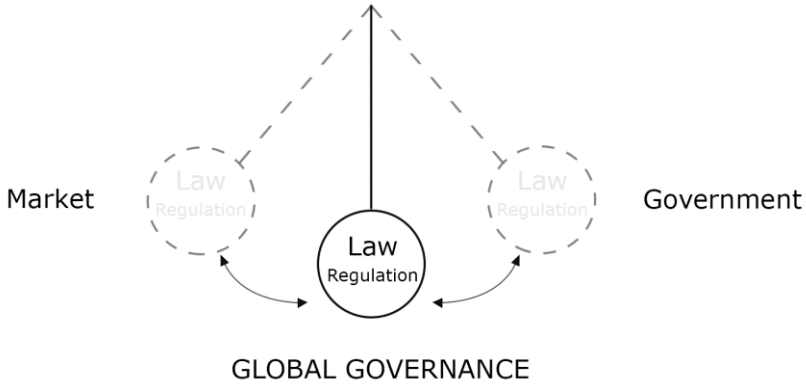
out by David Kennedy, "through the work of expertise, order and disorder are distributed unevenly, even inadvertently, among nations, economic sectors or classes, issues or problems through struggles about other things."[26] Ruling by experts can explain the global governance since the 1980s, characterized by the apparent paradox about the liberalization of markets accompanied by the intense regulation of institutions that protect the global players.



Picture no. 1: The balance between market and government via law/regulation in the global governance context.

The metaphorical image of the pendulum, swinging from side to side, schematically illustrate that government and market could not be polar alternatives, but rather complementary agents of an economic coordination in pursue of balance and more power in the global political economy. Just like stressed by both approaches the problems of the development agenda are complex and unique in its way in the sense that it is insufficient to explain how relations between government and market are de facto established disregarding the embeddedness of institutions.

Since the late 1800s, with the Sherman Act in the United States,[27] one possible way to study this ongoing relation between government and market is by underscoring the competition system. The basic assumption of the

[26] DAVID KENNEDY. A WORLD OF STRUGGLE: HOW POWER, LAW AND EXPERTISE SHAPE GLOBAL POLITICAL ECONOMY 19 (2016). *See also* PATRICK M. WOOD, TECHNOCRACY RISING: THE TROJAN HORSE OF GLOBAL TRANSFORMATION (2014).
[27] Sherman Act, 26 Stat. 209, 15 U.S.C. §§ 1–7 (1890).

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competition system is to generate goods for society by promoting an efficient economy, thus, any competition system implies a certain competition policy and law that carefully impose limits to economic power.

During 1990s an outbreak of implementation of new and reformed competition systems occurred around the world, mainly in Europe and Central Asia. The basic assumption for some political scientist and sociologists[28] is that this outbreak was a reflex of the neoliberal globalization,[29] hence competition system started to be described as a functional mechanism that empirically permit the concentration of economic power worldwide, despite the basic idea to generate goods for society. These authors highlight the important aspect that the discourse of competition system and law ignores asymmetries in the history, specially omits the colonialist and imperialist ideals, even the struggles for economic rights and the power of experts.[30]

Nevertheless, this paper offers a complementary account about the development of the competition system by focusing the institutional history and sociology. I present and discuss the embedded factors involved in C.A.D.E.'s case. In this sense, it is important to understand that different relations between government and market were important in shaping this institution in Brazil vis-à-vis the broader global context and ideals that influence these relations. I argue in the next section that the embeddedness can be revealed if we understand the importance of the institutional context, like the institutional learning and the institutional influences, as determinant for the development.

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[28] *See* WILLIAM DAVIES, THE LIMITS OF NEOLIBERALISM: AUTHORITY, SOVEREIGNTY AND THE LOGIC OF COMPETITION (1st ed., 2014) and HUBERT BUCH-HANSEN & ANGELA WIGGER, THE POLITICS OF EUROPEAN COMPETITION REGULATION: A CRITICAL POLITICAL ECONOMY PERSPECTIVE (1st ed., 2011).

[29] The paper refers to neoliberalism as a set of policies and rules that permits the extreme centralization and concentration of capital. Different from liberal tradition, neoliberal thought accepts that monopoly is not necessarily harmful if it proves to be efficient to the economy, thus, the idea of concentration has become a key-stone in the neoliberal theory and in practice justify the concentration of economic power within a few multinational corporations. Some examples of neoliberal policies are the privatization of state-owned enterprises, the deregulation of strategical economic sectors, and some examples of rules are the competition system and trade law that permits the liberalization of finance, encouraging stock market activities and the merge and acquisitions to happen. In this case rules are extremely functional for the capital expansion and concentration. *See, e.g.,* Gérad Duménil & Dominique Lévy, *Costs and Benefits of Neoliberalism: A Class Analysis*, *in* FINANCIALIZATION AND THE WORLD ECONOMY 17 (Gerald A. Epstein ed., 2005).

[30] *See supra* note 22.

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2.2. THE INSTITUTIONAL HISTORY AND SOCIOLOGY STANDPOINT OF VIEW

In the 1978 paper *Organizations and Decisions*, Niklas Luhmann argued that the origins of many political institutions were old corporations from religious brotherhoods that transformed into organizations of protection and discipline the political authority since the late Middle Ages in Europe. The German sociologist draws out two important observations from the example. First, Luhmann suggest that the origin and development of certain institutions depends on the network of interorganizational relations that stimulates its own growth. In addition, the example indicates that organizations influence each other and there are assumptions for the requirements of growth and constant reorganization of all other organizations.

Secondly, the example assume that the idea of organization implies a specific structure when society has reached a certain degree of complexity. This idea is explained by Luhmann by the observation of a co-evolution of the interrelations between organization and society, that become functionally differentiated.[31] From a systemic perspective, the shift from a pre-modern to a modern era was a reflect of the formation of a secular society with increase of complexity, marked by the emergence of functional differentiated systems.[32] Thus, specialized organizations – referred in the paper as institutions - emerged based on specific functions and programs.

For the paper, it is important to notice that this sociological point of view understands the relations between organization and as society in a dynamic perspective. In this sense, it is possible to discusses the increasingly grow of complexity and differentiation process in institutions. I argue that this discussion can be addressed by the idea of institutional influence and the importance of learning processes that reflect the orientations and routines applied to the new contexts and knowledge produced in each environment – derived from a legal developmentalist literature.

Institutional learning means to improve the performances of each institution in relation to others. The changes are gradual and improvements

[31] *See* NIKLAS LUHMANN, SOCIAL SYSTEMS (1995).
[32] *See* NIKLAS LUHMANN, OBSERVATIONS ON MODERNITY (William Whobrey trans., 1998).

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are always understood in the long term, since the entire learning process involves patience and reflection.

Accepting the idea of development as a learning process requires the comprehension of the dynamics involved, i.e., without a defined arrival point, and accepting situations as transient. The fact is that institutions have a great capacity for innovating to better meet demands according to the needs observed in time. However, there is no innovation without learning and knowledge, and cases of successful institutions underscore how it was important to renew their positions and reconsider their actions, and only manage this if they reconsider their own history to a certain extent.

Recently, Charles Sabel and Sanjay Reddy, for instance, emphasized that the important aspect in debating development is to discuss how to further learning conditions. The issue here is a critique of the notion of state-oriented development theories. After all, as already seen in the transplantable perspective, it is not enough to presuppose a single technical agent as holding the only power of decision, or as a pre-determined set of solutions or reforms to solve point problems. The scholars explain:

> Such a straightjacket conception of the order of things diminishes the attainment here and now of human potential, and accentuates the propensity to misapply technology and ideas, with too often disastrous consequences-discovered, and admitted, too late. No wonder development by dirigiste states and recipes seems to many more an invitation to collective self-abnegation than a reliable promise of regeneration.[33]

Solutions are built based on learning process. Here one avoids the mistake of a single, ready and finished solution, since one must take into account the specific needs and consider local experimentation as essential. It is a matter of looking at "*the learning centered approach to development*" as a process that is the result of a collective ability to construct and improve the institutions - which in this paper is called institutional learning and influences. Once again, Sabel

[33] *Supra* note 6, at 1-2.

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and Sanjay affirm that this approach recognizes the fundamental and pervasive incompleteness of our perceptions and cognitive capacities and at the same time the need for one another in other partially to overcome this incompleteness.

The fact is that considerable knowledge exists inside institutions and it cannot be ignored. This is because institutions produce knowledge that must be internalized in their procedures, norms, and above all in the routines of their employees. This accumulation of knowledge over time reflects a certain adjustment or reformulation of practices that are ultimately spontaneously or legally implemented by the institutions. Learning is not only to recognize the mistake and correct it, but to reconstruct the projects and plans of institutions per the new contexts and knowledge produced in practice.

This paper does not seek to normatively discuss models of institutional learning, or even to indicate the content of this learning – which would contradict the experimental concept of learning itself. The point is to highlight the importance of the qualitative gain when institutional learning is observed and implemented, insofar as routines, procedures, or strategies of the institutions are improved.

In the next topic, we apply this framework to describe and discuss C.A.D.E's experience.

3. CADE'S INSTITUTIONAL HISTORY

C.A.D.E.'s institutional history coincides with several moments of institutional learning and influences. In this case, it is enough to see how the performance of this agency gained space and repercussion in order to preserve economic competition in Brazil over time, and this transformation were recently consolidated by a new Antitrust Act.

As will be shown, the history of C.A.D.E. was marked by a series of failures and successes that can be described in four main moments, based on the specific legal arrangements concerning economic competition policies in Brazil: (a) the

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beginning of the interest to regulate economic competition during the period between 1889-1930, (b) the defense of a popular economy between the Vargas Era[34] and the Juscelino Kubitschek administration,[35] (c) the consolidation of the defense system at the beginning of the 1990s until (d) today, with the internalization of the institution.

These four periods reflect different arrangements and conjectures faced by the institution. The agendas of the executive changed, just like the policies for competition in Brazilian markets. Indeed, at certain times C.A.D.E. actions to implement a system to defend economic competition were a complete failure, but during the late 1990s, in light of redemocratization and liberalization of Brazilian market, C.A.D.E. played a key role to help recover the Brazilian economy. In this sense, it was indispensable for C.A.D.E. to reflect on its own structures and operations. Here, the Brazilian judiciary played an important role in shaping the agency structure and the 1988 Federal Constitution (CF/88) to define its powers.

In brief, the purpose of this section is to justify the development process as embedded – understood as unique and circumscribed process, determined by local experience. The point of interest is to highlight the transformations of C.A.D.E. in four moments,[36] and verify how it was possible

[34] Getúlio Vargas was president of Brazil in two different moments. The first term that lasted fifteen years (1930-1945) was marked by the coup d'état during the period that became known as Estado Novo. Subsequently, Vargas was elected by the popular vote and governed the country from 1951 until 1954, when he committed suicide. His regime was marked by protectionist and populist measures, supported by a nationalist discourse. The period mentioned in the article refers to the end of his first term, when many companies and public industries were formed in Brazil. During his government, there was also an expansion of labor and social rights, although such conquests served as an instrument of control during the authoritarian regime. For a historical presentation about Getútilo Vargas, see LIRA NETO, GETÚLIO 1930-1945: DO GOVERNO PROVISÓRIO À DITADURA DO ESTADO NOVO [*Vargas: from the Temporary Government to the Dictatorship of the New State*] (2013).

[35] Juscelino Kubitschek was president of Brazil during 1956-1961. His term was marked by a developmental and national integration project, marked by the construction of highways and, above all, by the construction of the new federal capital, Brasília. Kubitschek's term became known as the "golden years." Throughout his term, the Brazilian economy was rapidly industrialized, going from rural to urban.

[36] See for a general account about Brazil's antitrust policy history Tércio Sampaio Ferraz Jr., *Lei de Defesa da Concorrência: Origem Histórica e Base Constitucional* [*Competition Law: Historical Origin and Constitutional Basis*], 45 ARQUIVOS DO MINISTÉRIO DA JUSTIÇA 175, 176- 77 (1992). *See also* CClaudio Monteiro Considera & Paulo Corrêa, *The Political Economy of Antitrust Policy in Brazil - from Price Control to Competition Policy*, *in* ANNUAL PROCEEDINGS FOR THE FORDHAM UNIVERSITY SCHOOL OF LAW: INTERNATIONAL ANTITRUST LAW AND POLICY 533 (Barry E. Hawk ed., 2002), and most recently Francisco Todorov & Marcelo Maciel Torres Filho, *History of Competition Policy in Brazil: 1930-2010*, 57 THE ANTITRUST BULL. 207 (2012).

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to implement a system for defense of competition based on institutional learning and influences.

3.1. THE BEGINNING OF THE ECONOMIC COMPETITION PROTECTION

The first period refers to Brazil's First Republic (1889-1930), generally described as a liberal phase. The government operated de facto in an oligarchic and protectionist scheme in which all matters were manipulated by a dominant private elite to pursue their own interests. all rules and enforcements on the protection of economic relations were controlled by property owners of the sugar mills in the Northeast and the cattle-owning "colonels" in the sertão, and later, in a second moment, by the coffee planters of the Paraíba Valley and the West of São Paulo State. Coffee-planting was the greatest example of the concentration of economic power and the lack of economic protection policy. The only real interest was to reproduce the system of extensive monoculture for export.

It was in São Paulo and Minas Gerais states that "colonelism" as a political system reached its apex and contributed to the dominance the two states exercised over the federation. The "colonels" were involved with the governors' policies, who were also articulated by the president of the Republic, almost always coming from the two states. Usually the power of colonels was smaller in the periphery of the country, where export economy structures did not exist – such as in the south of Brazil which was populated predominantly by European immigrants who were small property owners.

In this structure, economic control corresponded to the interventions of the elites to strengthen their own production in market. In this way, the first initiative came from the main producer states (São Paulo, Minas Gerais and Rio de Janeiro) which, in 1906, celebrated the Taubaté Agreement (Convênio de Taubaté) to enhance the value of coffee, regulate its trade, promote increased consumption and create the Conversion Bank (Caixa de Conversão) establishing the minimum sales price.

This intervention mechanism is closely linked to the behavior of the foreign exchange. The Brazilian economist Celso Furtado indicated the way in

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which the coffee economy managed to 'socialize losses' and 'privatize profits.'[37] Consequently, this intervention process was complemented by monetary and financial mechanisms. A significant fact is that the Conversion Bank was already created in the first decade of the century, in 1908.

This price control structure depended greatly on foreign trade since Brazil exported coffee and imported all other manufactured products from Europe – this situation historically caused a disequilibrium in trade, resulting in a large public debt and the devaluing of Brazilian currency.[38] The result was that Brazil faced serious economic problems with the surplus international offer of coffee, without any entrenched insurance policy and with the international economic crisis background in 1929. This rudimentary economic scheme carried out by oligarchic structures collapsed and the institutional organization system on which it was based. Above all, the coffee defense system was dismantled.

3.2. THE DEFENSE OF POPULAR ECONOMY

The 1930s marked the beginning of the debate about the construction of a competition system to protect and ensure the market considering the growth of industries in Brazil. The objective of these discussions, especially with the proposal for amending the 1934 Constitution for establishing economic rights, was sanctioning and preventing the formation of industrial and trade monopolies, preserving free enterprise and the national economy.

A major fact of this second period was that the defense was carried out by the government intervention mechanisms in the economic domain with the creation of several executive bodies for specific markets, like the agriculture and the extractive industry. Monoculture elites did not have the same power in defining the political economy programs that were now marked as welfare policies. Besides these government bodies, a professional bureaucracy was also

[37] CELSO FURTADO, FORMAÇÃO ECONÔMICA DO BRASIL [*Economic Training of Brasil*] (2007).
[38] This was marked in Brazil history with the burning of surplus coffee stocks as the last measure by the Government to elevate the price of the product on the international market. The symbolic event indicated the complete economic deregulation of Brazil at the beginning of the Republic.

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established, such as the Administrative Department for Public Service (*Departamento Administrativo do Serviço Público* - D.A.S.P.).[39]

In the context of intense industrialization in Brazil, it is important to underscore the establishment of early state-owned companies such as Companhia Vale do Rio Doce and the official founding of Companhia Siderúrgica Nacional in 1942. The same modernization continued more intensively in Getúio Vargas second administration between 1950 and 1954 that marked a strong government intervention in the economy by implementing the Superintendency of Currency and Credit (*Superintendência da Moeda e do Crédito*), ensuring a process of import controls and, for our case, the implementation of strict measures concerning trade and price setting.

Legal measures were necessary to operate the welfare policies, like the Act No. 1.522/51 that authorized the federal government to intervene in the economy to ensure the free distribution of merchandise and essential services.[40] The main institutions that deals with this program were the Ministry of Labor, Industry and Trade, the Federal Committee of Supply and Prices (*Comissão Federal de Abastecimento e Preços* - hereinafter C.O.F.A.P.) and the auxiliary departments in the state and municipal levels.

C.O.F.A.P. and the auxiliary departments were empowered by the authority to purchase and distribute merchandise, set prices and control supplies. Thus, for instance, as to setting prices, the departments could promote economic inquiries, survey production costs, verify stocks and regulate the circulation of goods, according to the availability of goods and

[39] D.A.S.P. was to be a regulatory agency, for coordination and control, in charge of making procedures universal. But it faced problems throughout its existence, including the idea of how relations between State and society occurred at the time. The State was considered an opportunity for jobs without competitive exams, and the places were filled by personal nominations. During the first Vargas Administration (1930-1945), the State took on the role of inducing national development. The number of jobs expanded greatly, including the public sector. However, this growth followed the clientelist and job-giving logic, to the detriment of the university fostered by public competitive exams. The Brazilian State was becoming more modern, but continued the old practices. http://www.servidor.gov.br/institucional/historico_DASP.htm

[40] Decreto No. 1.522, de 26 de Dezembro de 1951, DIARIO OFICIAL DA UNIAO [D.O.U.] de 28.12.2008 (Braz.).

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services. In the 1960s, C.O.F.A.P. was replaced by the National Superintendency of Supply (*Superintendência Nacional do Abastecimento* - S.U.N.A.B.),[41] which implemented a policy for credit and development of production, expanded existing programs and operated the national system of warehouses and silos, all of which was to ensure a free distribution of merchandise and essential services.

At the same time as a series of institutions were established to protect the Brazilian economy, it must not be forgotten that the first antitrust legislation was enacted. This law sought only to discipline a series of infractions and abuses against the popular economy, and not to structure and organize a system to defend economic competition. As a matter of fact, the idea of protecting competition was seen by the politicians as nationalist rhetoric.

It is sufficient to consider the failure of Decree Law No. 7.666 of June 22, 1945 – known as "Malaia Law"[42] which established several acts against the social and economic order, instituting the Administrative Committee for Economic Defense (the former name of C.A.D.E.) to verify the existence of such acts and repress them. Once more, Luiz Carlos Delorme Prado, former C.A.D.E. Commissioner, explains that during the historical moment when this law was enacted, there was a strong opposition that considered the Act to be far too interventionist and influenced by leftist ideals.[43]

It was only in the 1960s, during the Goulart administration,[44] that new legislation came along allowing the government to intervene more strategically

[41] S.U.N.A.B. was extinguished by Decree No. 2.280, of July 24, 1997, and all its obligations and attributions were absorbed by the Treasury (Ministério da Fazenda. The Office of the Federa Budget of the Ministry of Planning and Budgets (Secretaria de Orçamento Federal do Ministério do Planejamento e Orçamento) was authorized to redistribute the balance of the budget endowments of the SUNAB after it had been closed.

[42] Decreto-lei No. 7.666, de 22 de Junho de 1945, DIARIO OFICIAL DA UNIAO [D.O.U.] de 22.06.1945 (Braz.). This statute became known as "the Malaia Law", referring to the nickname of its author, former Minister of Justice Agamenon Magalhães, given to him by journalist Assis Chateaubriand. http://www.alepe.pe.gov.br/sistemas/perfil/parlamentares/AgamenonMagalhaes/17.html

[43] The U.S. Department of State interpreted the law as an act of economic nationalism and pressured the Vargas administration to revoke it. Sectors of the opposition protested the measure calling the Committee for Economic Defense a Nazi-Fascist instrument that threatened the Brazilian economy. The law was immediately revoked by Provisional President José Linhares a few days after Vargas was deposed. *See supra* note 2, at 102.

[44] João Goulart was president of Brazil from 1961-1964, his term was interrupted by the military coup of 1964. During his government, Brazil suffered from inflation and its main policy was to

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on the markets. This occurred with the enactment of Act No.4.137 of 1962,[45] article 8 of which created C.A.D.E. with national jurisdiction. The 1962 C.A.D.E. was a small collegiate decision-making agency, which, in those days, oversaw and controlled the abuse of economic power, promoting the judgment of infractions. In certain cases, C.A.D.E. could ask for judicial intervention to apply sanctions against the domination of markets, raising prices without fair cause, natural monopolies and the formation of economic groups.

However, it is interesting to underscore that the 1962 C.A.D.E. was not part of a structure program to defend economic competition. The discussion of how to formulate a system to defend competition was not on the political agenda. At that time, economic facts, free competition and monopoly would have sounded like odd political economic programs that necessarily had to be prevented by government in the name of defending a popular economy. In fact, Brazilian markets were controlled by multinational companies that organized themselves in a cartelized fashion authorized by government.[46]

The fact is that the government economic program was oriented to protect the popular economy and these measures were carried out during populist governments. In this sense, it is worth pointing out that the period between 1930 and 1945 was a great moment of social and economic legislation in Brazil. Nevertheless, this legislation was introduced in an environment of low political participation and precarious enforcement of civil rights. The problem was that social and economic protection were distributed to ensure continued populist government control of Brazilian society.

Hence, for the antitrust legislation, notions such as free competition and monopoly were ideas to be criticized. Some explanations were: no producer would have the means to exert real control over prices in a free competition, there was danger in free competition, since new suppliers or consumers constantly were added, and because of the monopoly it would be impossible for new suppliers to enter the market.

perform the basic reforms - economic and social measures of nationalist character that defended a great intervention power of the state in the economy.

[45] Lei No. 4.137, de 10 de Setembro de 1962 DIARIO OFICIAL DA UNIAO [D.O.U.] de 27.11.1962 (Braz.).

[46] See Kurt Rudolf Mirow. A ditadura dos cartéis [The cartel dictatorship] (1977).

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Economists point out that the populist economic programs turned out to be disastrous measures for Brazil.[47] It was wrongly assumed that price control could partly attenuate the inflationary forces in the 1950s. However, all it did was provoke price distortions, leading to scarcity in several areas of the economy. In addition, price controls triggered a process of rapid growth of state-owned companies since fixed tariffs for public utility service prices were not profitable for foreign companies, the outcome being difficulties in ensuring the expansion and modernization of private industries.[48] The government managed to consolidate its position in the field of electricity generation and distribution, public transport and other services that were essential for society.

The Kubitschek administration (1964-1967) is a good example that confirmed - in a planned fashion - the consolidation of this industrial development. This consolidation had already begun in the Vargas Era, above all with the implementation of the Plan of Goals (*Plano de Metas*) and growth of the base industry carried out exclusively by the executive.

During this second period, government intervention in the economy was a form of protection of the popular economy (and not of competition). As described by the Brazilian scholar Alberto Venâncio Filho the economic government policy for antitrust legislation and for establishing prices was affiliated to a certain protectionist environment which practically disappeared in the years after the end of the military dictatorship.[49] This was above all because competition, the golden rule of the market, was to be guaranteed by the executive in welfare policies.

3.3. THE CONSOLIDATION OF THE SBDC

The executive modernization process that occurred in the 1990s marked a decisive change of vision of the paradigm of public administration, and specifically about the protection of competition in Brazil. According to former minister of administration and state reform, Bresser Pereira, the 1990s

[47] *See* Werner Baer, Isaac Kerstenetzky & Annibal V. Villela, *The changing role of the State in the Brazilian economy*. WORLD DEV. J., 1973, at 23.
[48] *See supra* note 29.
[49] *See* ALBERTO VENÂNCIO FILHO, A INTERVENÇÃO DO ESTADO NO DOMÍNIO ECONÔMICO: O DIREITO PÚBLICO ECONÔMICO NO BRASIL (1998) [*State Intervention in the Economy - Public Economic Law in Brazil*].

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confirmed that the welfare policies did not thrive, mainly due to serious fiscal crises and public indebtedness that had marked the country's economy since the 1980s. The evidence was that the traditional protections guarantees and the enforcement of social rights were no longer successfully fulfilled. In short, government and market could not be seen as polar alternatives in Brazil's new economic policies.[50]

There were four main components of Brazil's administration reform, influenced by the Washington Consensus: (i) a new delimitation of state functions, with a privatization program; (ii) reduction of the degree of state interference in the economy through deregulation programs, and increasing the use of market control mechanisms; (iii) implementation of a management-oriented reasoning towards results and (iv) amplifying mechanisms of direct representative democracy, opening space for more social control of public decision-making.

In the economic area, it is important to underscore the introduction of the Real Plan (*Plano Real*), which inaugurated a new phase of the fight against inflation despite the failure of other plans. One of the aims of the plan was also to ensure free competition in various activities – even in some public services. Instead of direct intervention, government has become the main regulatory agent of economic activity just like expressed in the Article 174 CF/88 that states as the normative and regulating agent of economic activity, the state shall, in the manner set forth by law, perform the functions of control, incentive and planning, the latter being binding for the public sector and indicative for the private sector.

CF/88 marked a new structure for the interactions between regulatory sectors and the antitrust regime in Brazil. As pointed out by Brazilians scholars, Caio Mario Pereira Neto and José Inácio Filho, the government assumed two distinct but complementary roles in creating spaces for competition where it was non-existent and protection of these spaces opened

[50] *See* Luiz Carlos Bresser-Pereira, *State Reform in the 1990s, Logic and Control Mechanisms, in* INSTITUTIONS AND THE ROLE OF THE STATE 175 (Leonardo Burlamaqui, Ana Célia Castro & Ha-Joon Chang eds., 2000).

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by regulation (enforcement of antitrust violations within regulated sectors).[51] Thus, C.A.D.E.'s power was strengthened since it was now the main agency to foster competition by fully exerting its tasks in competition adjudication in spaces non-regulated or by evaluating the compatibility of regulatory policy with competition law.

This new transformation required a new normative framework and marked the enactment of the most important Brazilian Antitrust Act, No. 8.884/1994.[52] Its purpose was to implement an unprecedented policy of competition in the country and enable the interaction between regulatory law and antitrust regime to be fully articulated. This Act, in fact, inaugurated a system to defend the competition system, consisting of the Secretariat for Economic Monitoring (*Secretaria de Acompanhamento Econômico* - S.E.A.E.) of the Ministry of Finance, the Secretariat for Economic Defense (*Secretaria de Defesa Econômica* - hereinafter S.D.E.) of the Ministry of Justice, as fact-finding agencies, and C.A.D.E. as the Administrative Court connected to the Ministry of Justice.

The dominant characteristic at the time was to build an environment in which dissemination and defense of competition were to take place. C.A.D.E., which until that time had played a marginal role in economic life in Brazil, took on a leadership role and became an independent custodian of the free competition principle. The agenda was marked with the purpose of consolidating the best practices and promoting an environment of competition neutrality.[53]

In this transformative scenario, it is important also to highlight other statutes like Act No. 8.158/1991,[54] which modified the tasks assigned to C.A.D.E. - as foreseen in 1962 - classifying it as a judicial agency within the structure of the Ministry of Justice. Thus, the agency began to function at the Secretariat of Economic Law, and then, with the Antitrust Act, established C.A.D.E.'s own

[51] *See* Caio Mário da Silva Pereira Neto & José Inacio Ferraz de Almeida Prado Filho, *Spaces and Interfaces Between Regulation and Competition: the Approach of CADE* 12 REVISTA DIREITO GV 13 (2016).
[52] Lei No. 8.884, de 11 de Junho de 1994, DIARIO OFICIAL DA UNIAO [D.O.U.] de 13.6.1994 (Braz.).
[53] See Vinicius Marques de Carvalho. A política de defesa da concorrência quatro anos depois: ainda em busa de melhores práticas? [The competition policy four years later: still in search of best practices?] (2015).
[54] Lei No. 8.158, de 8 de Janeiro de 1991, DIARIO OFICIAL DA UNIAO [D.O.U.] de 9.1.1991 (Braz.).

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structure and autonomy that became a federal agency, responsible for judging proceedings. In addition, based on the fact-finding by S.D.E. and on the analysis of reports, this agency also became important to decide on infractions against free competition, and as a judge to approve acts of concentration.

The creation of specialized agencies, such as C.A.D.E. and S.D.E. provided evidence that there was institutional acknowledgment about how to deal with the complexity of economic activity in the country. Now the promotion of structures to protect competition was no longer considered a nationalist discourse, but as an essential key to the economic development of Brazil.

The entire political and economic agenda of the government began to create compatibility between the values of economic efficiency and consumer well-being with acknowledgement of the principle of free competition, foreseen in paragraph IV of article 170 of the Federal Constitution. In other words, as already mentioned, it became the duty of the government to observe, control and regulate the economic environment so that companies with market power would not abuse this power to harm free competition.

In this sense, the institutionalization of a specific agency like C.A.D.E. was decisive to inaugurate a defense system. The Act attributed great discretionary power to C.A.D.E., and, over the years, the jurisprudence of the Economic Council consolidated several opinions about infractions to the economic order, ensuring a certain predictability and legal certainty that were important for the economic growth observed in Brazil in late 1990s and beginning of 2000s.

Indeed, it is interesting to find that the decisions and administrative precedents generated by C.A.D.E. become real indicators and signal of the country's political and economic agenda of the government, above all in the matter of competition policies. This signaling can be understood as the legal and economic ideas that form the bases of the competition law enforcement in Brazil, and reveals certain political and economic preferences – as already mention for certain analyses this permitted more concentration of economic

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power in the country since C.A.D.E.'s policies are aligned with neoliberal ideals.[55]

It is important to underscore that institutionally C.A.D.E. as an "administrative court" was directly influenced by the Brazilian judiciary structure and by the Ministry of Justice as a political organ, since its actions began to indicate the lines of public policies for competition.[56] In the next topic we highlight the institutional influences of C.A.D.E. during the 1990s.

3.4. CADE AS AN ADMINISTRATIVE COURT

Nowadays C.A.D.E. constantly exercises functions similar to a judicial court in Brazil on competition matters and it is institutionally surrounded by rites and solemnities like those of the Judiciary. Regarding its organization, C.A.D.E. is a collegiate body composed of six members (commissioners) and a president, all with four-year terms without the possibility of reappointment.

Some features that resemble the performance of judges that might be worth mentioning are the fact that commissioners have functional guarantees, such as judicial independence and the prohibition of taking certain positions that would potentially affect the impartiality of the court. Just like final appellate courts, commissioners also do not submit to any higher authority and have unrestricted freedom to interpret reasonably the evidence produced while forbidden to participate in politically partisan activities.

Another aspect similarly related to the Brazilian Judiciary is that C.A.D.E. watches over the technical quality of its members and opinions through a meritocratic (and not political) nomination process. The

[55] An important critique about this moment can be analyzed regarding the fact that the development of the competition in 1990s until today contributed to the production of an economic arrangement propelled by neoliberal ideals in Brazil. For instance, Brazilian scholar Iagê Miola argued according to an empirical analysis that "the data gathered from the Brazilian case illustrate that, from 1994 to 2010, economic power was in general regulated in a way to be compatible with – not contradictory to – the neoliberal understanding on how should competition occur, i.e. how big should corporations be and hence how should the economy work" (p. 680). Miola argues that C.A.D.E.'s interpretation advocates for concentration as something desirable and his data revealed that in most cases the agency decided in favor of corporations' concentration. *See* Iagê Miola, *Competition law and neoliberalism: the regulation of economic concentration in Brazil,* REVISTA DIREITO E PRÁXIS, 2016, at 643. *See also* CARLOS ALBERTO BELO, A AUTONOMIA FRUSTRADA: O CADE E O PODER ECONÔMICO [*The Thwarted Autonomy: CADE and Economic Power*] (2005).

[56] *See* Diogo R. Coutinho, *O Direito nas Políticas Públicas*, *in* CONTRATOS PÚBLICOS E DIREITO ADMINISTRATIVO (Carlos Ari Sundfeld & Guilherme Jardim Jurksaitis eds., 2015).

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appointments require approval by the Federal Senate, just like some positions in the Judiciary, such as the positions of Justices in the Supreme Federal Court or in the Superior Court of Justice.

However, a major difference between the two models is the profile of the composition of the court. C.A.D.E. is not only composed by former lawyers or jurists, but also engineers, economists, and other antitrust practitioners - true experts on the grounds of mobilized technical knowledge – and in this sense the court's composition may signal a greater diversity vis-à-vis the Judiciary.[57]

The plurality in the composition can be justified in theory by the perception that the court is a collegiate body that proposes to attend different points of view. Given the functioning of the trial sessions in which the debate and the exchange of arguments between the peers exists, there is, in a certain way, a situation conducive to the common conviction that may generate the possibility of some decisions forming a guideline and representing different points of view. It is possible to systematize as follows:

Table 1. Comparative approach of Brazilian Judiciary and C.A.D.E.

	Judiciary	*CADE*
Function	Judicial	Administrative-adjucatory
Court	Deliberative Collegiate Body, except first instance (monocratic judgment)	Deliberative Collegiate
Term	Life, except for some positions	Four years, non-renewable
Guarantees	Functional and Impartial	Functional and Impartial
Composition	Single Composition (requires only the bachelor's degree in law and at least three years of legal experience before sitting for the judicial exam)	Plural Composition (Anyone holding a bachelor's degree with well-known legal or economic knowledge and unblemished reputation, may be appointed by the President of the Republic, after approval by the Federal Senate)

[57] Under the new Antitrust Act, anyone over thirty years of age with legal or economic knowledge and unblemished reputation may be a commissioner. Different is the case of the Judiciary in Brazil which admission occurs by competition of public tests and titles made only by law graduates, meeting the temporary requirement of three years of legal training.

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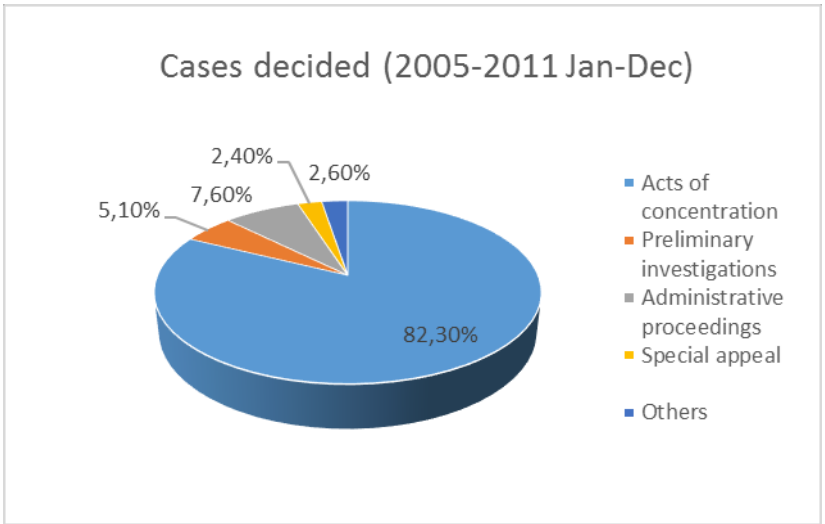
Among its duties, C.A.D.E. plays a preventive role insofar as it analyzes structural changes in the market, presented in the form of acts of concentration – market agreements considered to be harmful to free competition, and a repressive role that refers to judgments of administrative proceedings for repressing infractions and abuse against the economic order, such as: cartels, predatory pricing, exclusive contracts and others.

In the graph below, the distribution of activities during the period from January 2005 to December 2011 can be noted, in which 82.3% of the proceedings adjudicated by the C.A.D.E. plenary were acts of concentration, 7.6% preliminary investigations and 5.1% administrative proceedings.



Picture no.2: C.A.D.E. em números/Cases decided (2005-2011 Jan-Dec)

At the beginning of the twenty-first Century, the work of C.A.D.E. became more intensive and important as evidenced by the growth of fines collected due to infractions, or the untimely presentation of an act of concentration, in 2003 2.9 million reais were collected and, five years later, in 2008, more than 64 million reais.

The great number of proceedings filed and adjudicated at C.A.D.E. from the year 2000 to April 2012 can also be seen. These are significant figures that require a well-defined structure to provide a good quality response to the

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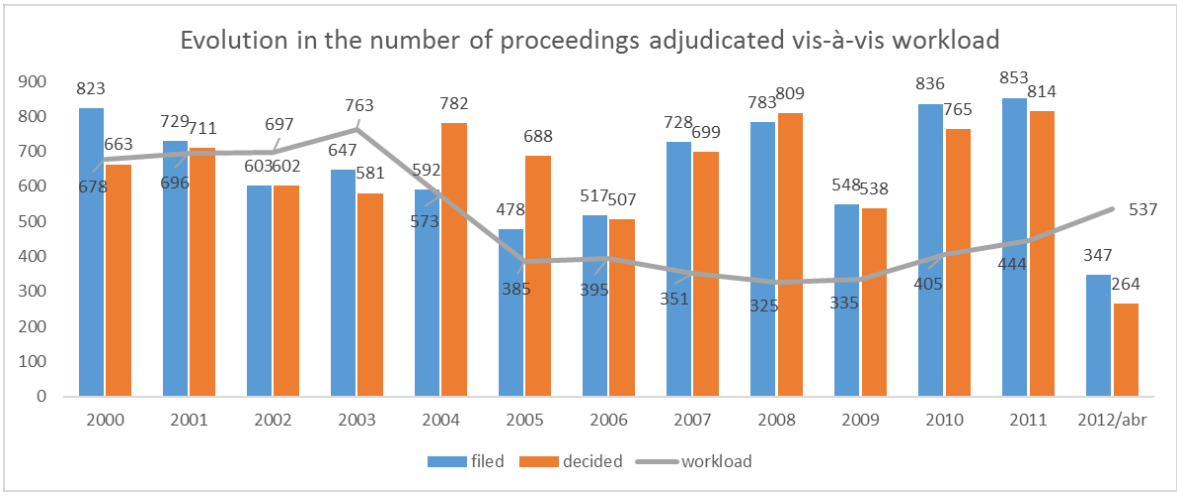
volume of the demands. It is emphasized that in 2000, 823 proceedings were filed, and in 2011, 814 proceedings.



Picture no.3: C.A.D.E. em números/Evolution in the number of proceedings adjudicated vis-à-vis workload

In this evolution of the filing and adjudication of proceedings, it is important to also consider the capacity of C.A.D.E. to reinforce its jurisprudence and care to uphold its opinions when they are reviewed by the Judiciary – a hypothesis which could be seen as a possibility of analyzing the quality of the work done by C.A.D.E. itself.[58] It is above all necessary to preserve the rationality and technical strictness of antitrust analysis, since a certain logic must be obeyed in the economic analysis of law and a synchronization of the administrative and judicial levels. Otherwise, there could be serious problems for economic activity and judicial safety itself could be reduced.

According to the Annual Management Report for 2010, the judicial defense of C.A.D.E. is still improving, and in 84% of the cases the decision by

[58] A study before the new Antitrust Act about the judicial review of C.A.D.E.'s decisions reveals that eighteen acts of concentration and twenty-one administrative proceedings were overruled because of a number of defects observed. *See* FABRÍCIO ANTONIO CARDIM DE ALMEIDA ET. AL., REVISÃO JUDICIAL DAS DECISÕES DO CONSELHO ADMINISTRATIVO DE DEFESA ECONÔMICA (CADE): PESQUISA EMPÍRICA E APLICADA SOBRE OS CASOS JULGADOS PELOS TRIBUNAIS REGIONAIS FEDERAIS (TRFS), SUPERIOR TRIBUNAL DE JUSTIÇA (STJ) E SUPREMO TRIBUNAL FEDERAL (STF) (2011)

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C.A.D.E. is confirmed by the Judiciary – which may also show a clear improvement of its performance.

3.5. THE NEW CADE

One of the main problems perceived with the 1994 Antitrust Act was the absence of a requirement for prior approval of acts of concentration – the prior presentation would enable C.A.D.E. to apply preventive measures, not only corrective ones, making it more effective and simple for authorities to impose restrictions.

Another important problem recognized was regarding the institutional design of S.B.D.C. It was considered extremely complex since it had different authorities (S.D.E., S.E.A.E. and C.A.D.E.), and the plenary decisions required the participation of many agents (from S.D.E., from S.E.A.E., from the C.A.D.E. Attorney's Office and from the Department of Justice). Many lawyers and economists criticized S.B.D.C. as a completely anachronistic and excessively bureaucratic multiplication of agencies. The Brazilian government and economy simply could not allow an agency like that to continue in the same form.

The outcome was that administrative proceedings were very slow and, in many cases, it was impossible to prevent adverse effects on the market due to acts of concentration, or even to implement decisions. In this sense, the implementation of a section just to enforce C.A.D.E.'s decisions was an important improvement. This was coordinated by the Attorney's Office of C.A.D.E. (Pro.C.A.D.E.)[59] created in 2009, which led to an increase of technical knowledge regarding collection, rationalizing the scarce human and material resources of the agency.

[59] The Attorney's Office to the Administrative Council for Economic Defense (ProC.A.D.E.) is a department of the Federal Attorney's Office (P.G.F. - Procuradoria Geral Federal), of the Advocate General of the Union (A.G.U. - Advocacia Geral da União) and its duties are to provide consultancy and legal advice to the Administrative Council of Economic Defense (C.A.D.E.), to represent this federal agency in court, to register its credits in active debt and collect them in a friendly or judicial manner, and also see that the determinations or the Plenary are carried out, if necessary implementing the orders based on its decisions.

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Another reform to overcome these problems happened in the beginning of the 2010s, with a new Antitrust Act No. 12.529/2011. This new act focused on the process of C.a.d.e.'s autonomy, seeking to isolate and protect the antitrust authority from the interference of other regulatory policies. There is now an important division of competencies, avoiding further disruption and contributing to cooperation between Brazilian regulatory agencies, especially the Central Bank. Among the main institutional changes was in the analysis of acts of concentration, since now any merger or structural changes in businesses with significant impacts on the market must be submitted in advance and can only be concluded after approval by C.A.D.E. In addition, the new Act also simplified the institution resulting in greater efficiency, and avoiding the slowness in coming to decisions.

The new C.A.D.E. is composed of the General Superintendency and the Department of Economic Studies, both fact-finding agencies for administrative proceedings to analyze or find out information, and the Administrative Court responsible for the trial.

All these changes were important improvements resulting from a continuous institutional learning. Today, C.A.D.E. modified national and consumer economic life. It created a safer space for business so that, because of the demands of the market itself and of public interests, all economic transactions can be performed without problems.

Recent data indicates that C.A.D.E. can decide the administrative proceedings and concentration acts more rapidly the before. In 2015 for instance, C.A.D.E. decided 384 concentration acts and fifty-two administrative proceedings cases. There have been convictions in thirty-nine cases, and fines totaled approximately 524 million Brazilian reais.

(See Table in the next page)

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Table 2. Total of Fine Collected per year by C.A.D.E.

Year	Amount Collected
2011	**R$ 25.361.528,07**
2012	**R$ 31.518.649,02**
2013	**R$ 45.692.670,28**
2014	**R$ 91.857.098,46**
2015	**R$ 169.098.785,48**
2016	**R$ 523.954.270,69**

Also, C.A.D.E. started to foster international cooperation and establishing international agreements. In this sense, thirty-one cases were investigated in cooperation with other antitrust agencies in 2015, whether for the fight against international cartels or for the control of transnational mergers. Due to its recent positive results, C.A.D.E. received national and international recognitions.[60]

Lastly, the new C.A.D.E. truly incorporated institutional learning processes in its structures, defining and implementing a strategic benchmark each year. The strategic benchmark is also aligned to Brazil's four-year governmental plan (Plano Plurianual). The main initiatives for the institution in the period of 2016-2019 are: strengthening of the cartel combat policy; the systematization of C.A.D.E.'s case law and the dissemination of the competition culture in Brazil.

[60] The agency won the title of antitrust agency of the Americas in 2014, awarded by the journal *Global Competition Review* and has maintained the four-star ranking in the journal annual ranking. In the national scenario, the agency was awarded the third Competition of Good Practices, promoted by the Federal Comptroller's Office, in the category of Promotion of Active and / or Passive Transparency, by the public research module on administrative processes developed.

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4. FINAL REMARKS

During the last decades economic analysis and institutions of control were redifined in Brazil. One might say, today, that the use of legislation for competition defense is not out of tune with the best international practices, but C.A.D.E. also found its own way, creating its best practices. This is a conclusive finding on reports from the Organization for Economic Cooperation and Development and C.A.D.E. is very responsible for the actual scenario.

C.A.D.E. is a unique institution in the Brazilian legal system. It is the result of a transformation that occurred over Brazilian antitrust history – as pointed out in four different moments. During this paper, we mention the different structures of C.A.D.E.: the Malaia law C.A.D.E.; the 1962 C.A.D.E. – the collegiate agency of the Ministry of Justice; the 1994 C.A.D.E. – a federal agency - and the C.A.D.E. according to the new Antitrust Act. These different structures represent the change from a protectionist model to a greater emphasis on flexibility between the market and government, even though the competition discourse still omits the historical asymmetries of the Brazilian society and the power of the experts.

CF/88 was also decisive because of its protection of free competition as a legal principle of the economic order and, for this reason allowed coordination to be made via the market with restrictions by the government with competition and regulation norms. In this scenario, the new C.A.D.E. become stronger with a prominent position in the S.B.D.C., and as the main controller of the merge of private economic agents in the country.

We also underscore that the implementation of a policy and a structure to defend competition did not occur as a mere endowment of factors in Brazil. Rather it was part of a history of successes and failures of models and interests. The transformations analyzed support the notion that institutional performance depends on a certain ability of the institutions to learn lessons from the past in order to assimilate changes, in a process of permanent reconstruction of the institutional space and in relation with other institutions.

Since the learning process is a continuous and ongoing activity, C.A.D.E. will face new challenges and adversities. Already some positive achievements

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of C.A.D.E. are being threatened by budgetary issues. Since the new Antitrust Act, C.A.D.E.'s budget has not been extended in proportion to the increase in its duties, which generates the dependence on the assignment and requisition of public servants for its operation.[61]

In the same sense, C.A.D.E. cannot be said to be in danger of becoming a "SuperC.A.D.E." – concentrating all the political economy decisions into its jurisdiction. This is because C.A.D.E. is part of a complex system of competition defense – its attributions are limited, and above all, it is controlled by the executive branch and via judicial review.[62]

In addition, we must still highlight that one of the main problems that the new C.A.D.E. does not tackle is the over-centralization of its headquarters in Brasília, Brazil's federal capital. Given the increase in work and the many regional features of competition infringements, it would be more suitable for the implementation of best practices, education and training[63] and – foremost - effectiveness of the S.B.D.C. to decentralize C.A.D.E.'s functions to local offices, with at least one in each of the five regions of Brazil.

Finally, since 2013, many protests have taken place on the streets of Brazil. Many of them had a common cause: dissatisfaction with the political system and the wave of corruption scandals involving private companies, the executive branch and legislature that were revealed by the judiciary. The biggest case is "Operação Lava Jato"—the country's biggest corruption and money laundering case involving the state-controlled oil company Petrobras. In this context, it must be highlighted that C.A.D.E. has been playing an important role to help recover Brazil's economy from a severe recession since

[61] According to C.A.D.E.'s last annual report, the restructuring promoted in 2012 has raised C.A.D.E. expenses, but there has been no corresponding increase in the budget, which has limited investment in training and information technology, threatening to carry out search and seizure operations and the proper functioning of the agency. In 2015, this scenario worsened, with a nominal reduction of 5.75% compared to the budget approved in 2014, in addition to the limitation of budget execution.

[62] Celso Campilongo. Supercade e a nova Lei do CADE, *supra* note 2.

[63] The actual main goals of the S.B.D.C. program are to expanded new learning mechanisms, like the School of Defense of Competition with a system of distant education and new laboratories for analysis and investigation of cartels. The School should be guarantee at least one laboratory in each region of the country in order to review the norms for proceedings to make them shorter, improving obedience to the constitutional principles of the adversarial system, legal defense and reasonable duration of administrative proceedings and to review the programs of leniency and compliance, encouraging the economic agents to join these programs aiming are more effective prevention and repression of violations of the economic order.

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the outbreak of the corruption scandal. C.A.D.E. is currently conducting thirty investigations of cartels formed by companies involved in "Operação Lava Jato" and its actions are truly transforming Brazil's political economy practices for a more accountable, safer and transparent business environment.

In contrast to a notion of development as transplantable, it is important to consider it as a learning process of adjustments. C.A.D.E.'s case revealed that in Brazil the construction of the competition system occurred in an embedded context, coping with the market and the government interests. A further analysis would seek to understand if this institution transformed the asymmetrical discourse of competition law in Brazil vis-à-vis global governance.

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Should Local Governments Be Included in the Constitution? A Comparative Analysis Between the U.S. and Brazilian Supreme Courts' Reasoning Regarding Annexation Laws

CAROLINA ARLOTA[†]

TABLE OF CONTENTS: 1. Introduction; 2. The U.S. Scenario; 3. The Brazilian Scenario; 4. Discussion of Research Findings; 4.1. General Analysis of the Comparison and Related Consequences for Fundamental Rights; 4.2. Insights Based on Constitutional Design; 5. Conclusion.

ABSTRACT: Annexation of local governments is a contentious topic. Litigation of annexation often addresses important constitutional provisions, such as property rights, federalism, limitations to police powers, equality and, more specifically, the Voting Rights Act. The United States Constitution is famously silent about local governments. In light of this omission and considering individual constitutional rights, would it make a difference to have local governments in the constitutional text? And to whom would it matter the most? This research developed an original dataset to answer those questions. This article focuses on annexation as proxy for local powers, and it compares the U.S. federalism scheme with the Brazilian unprecedented experience of leveling local governments alongside the states and the federal union in the Constitution of 1988. This research is unique in its comparison of the reasoning of the U.S. Supreme Court (U.S.S.C.) and its Brazilian counterpart, the Supremo Tribunal Federal (S.T.F.), with regard to annexation laws. The main contributions of this study to the literature are straightforward. First, it advances the literature on constitutional design by focusing on local governments, instead of states and the federal union. Second, and related to such an advancement, this paper departs from traditional federalism comparisons which were restricted to developed countries. Third, this research provides evidence contradicting previous claims that the U.S. constitutional omission of local governments was a failure of constitutional design relating to future matters. In addition, this study analyzes the consequences of the Brazilian constitutional design. This article concludes that there is no evidence supporting the proposition that the inclusion of municipalities as federal actors is necessarily superior to the current comparative trend that uses the dual spheres system of the U.S. federalism as a paradigm. Therefore, this research leads to unexpected results and provides evidence that contradicts the understanding of the U.S. constitutional omission of local governments as a failure of constitutional design.

KEYWORDS: *Constitutional Design; U.S. Federalism; Annexation Law; United States Supreme Court; Local Governments; Comparative Law; Law and Development; Voting Rights Act; Legal Transplants; Brazilian Federalism.*

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1. INTRODUCTION

Annexation is a contentious topic, being the most frequent form of boundary change in the United States.[1] Setting boundaries is of key importance for local governments with regard to a variety of purposes: tax base, jurisdiction, regulations, access to public services and rights to vote.[2] In 2015, there were 89,004 local government entities in the United States, and they levied approximately 6.6% of this country's (G.D.P.).[3] Claims referring to annexation of local governments in light of constitutional rights have significantly increased in the United States.[4] The U.S. Constitution is famously silent about several provisions, including local governments. In light of this omission and individual constitutional rights, would it make a difference to have local governments in the constitutional text? And to whom would it matter the most? This article aims at answering these questions. It focuses on annexation as proxy for local powers, considering the absence of local governments' provisions in the U.S. Constitution. It compares this scheme with the unprecedented Brazilian experience of leveling local governments alongside the states and the federal union in the Constitution of 1988.[5]

This research compares the reasoning of the U.S. Supreme Court (hereinafter U.S.S.C.) with its Brazilian counterpart, the Superior Tribunal

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[1] *See* RICHARD BRIFFAULT & LAURIE REYNOLDS, CASES AND MATERIALS ON STATE AND LOCAL GOVERNMENT LAW 210-11 (7th ed. 2008).

[2] *See* Christopher J. Tyson, *Annexation and the Mid-Size Metropolis: New Insights in the Age of Mobile Capital*, 73 U. PITT. L. REV., 505, 506-61 (2012).

Reports There Are 89,004 Local Governments in the United States, U.S. CENSUS BUREAU (Aug. 30, 2012), https://www.census.gov/newsroom/releases/archives/governments/cb12-161.html. Local governments levied, in taxes, $1303 billion in 2015. *See Government Revenue Details*, US GOVERNMENT REVENUE (August 4, 2016), www.usgovernmentrevenue.com/numbers. Brazil currently has 5564 local governments, with revenue and mandatory transfers from the union reaching 8.6% of the Brazilian G.D.P.. *See Panorama 2011 bulletin*, FRENTE NACIONAL DE PREFEITOS (Feb. 9, 2015).

[4] Along those lines and stressing that, historically, state governments legitimized racially, national origin and class related discrimination: see Michelle Wilde Anderson, *Cities Inside Out: Race, Poverty, and Exclusion at the Urban Fringe*, 55 UCLA L. REV. 1095, 1095-160 (2008). For an illustration, see Chart I of this paper.

[5] For an analysis of Brazilian federalism, see CHARLES D. COLE, COMPARATIVE CONSTITUTIONAL LAW: BRAZIL AND UNITED STATES 32-33 (2d ed. 2008).

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Federal (hereinafter S.T.F.), in relation to annexation laws.[6] Federalism itself has been associated with the success of the U.S. constitutionalism.[7] As the U.S. federal experience inspired Brazil, implications concerning comparative constitutional design are considered.[8]

A literature review on constitutional design reveals a multiplicity of approaches.[9] Regardless, studies on local governments remain largely overlooked, despite being a relevant factor for fostering democracy.[10] As a product of institutional choices and continuing experiences, the better a constitutional design is, the more it should promote democracy by avoiding permanent political conflict.[11] As litigation increases, less institutional predictability can exist, and economic growth is, therefore, jeopardized.[12] Despite belonging to distinct legal traditions, both courts are independent, with similar jurisdiction when judging issues of local governments.[13] In both countries, such subject matter is generally dealt with at the state level, and the Courts have jurisdiction only if specific violations of the federal Constitution occur.[14]

Insights based on constitutional design also contend that the scope and the size of countries are relevant.[15] In this direction, a comparison between Brazil and the United States is pertinent, because both countries display

[6] The dataset for this research encompasses the decisions of the U.S. Supreme Court during the long tenure of the U.S. Constitution until February 2014, and the decisions of the S.T.F. – during the Constitution of 1988 until the same year. 2014 is the most recent year for which data could be gathered.

[7] *See* Keith S. Rosenn, *The Success of Constitutionalism in the United States and Its Failure in Latin America: An Explanation*, 22 U. MIAMI INT'L & COMP. L. REV. 1, 9-20 (1990).

[8] The study of comparative constitutional law has been founded on the U.S. Constitution. MARK TUSHNET, *Comparative Law and National Identity, in* THE OXFORD HANDBOOK OF COMPARATIVE LAW 1226 (Mathias Reimann & Reinhard Zimmermann eds., 2008).

[9] This research uses expression "constitutional design," despite its intrinsic limitations, including how misleading the notion of design might be when applied to the complexity of social reality. TOM GINSBURG, COMPARATIVE CONSTITUTIONAL DESIGN 1-2 (2012).

[10] *See* SUJIT CHOUDHRY & NATHAN HUME, *Federalism, devolution and secession: from classical to post-conflict federalism, in* COMPARATIVE CONSTITUTIONAL LAW 377 (Tom Ginsburg & Rosalind Dixon eds., 2011).

[11] *See* GINSBURG, *supra* note 9, at 10.

[12] *See* Ran Hirschl, *The "Design Sciences" and Constitutional "Success"*, 87 TEX. L. REV. 1339, 1339-74 (2009).

[13] Independence in the sense that there is no external and direct interference with each Supreme Court's final decision in a given case.

[14] Even in consideration of the constitutional amendments that occurred in Brazil in 1996 and 2008, the annexation of municipality occurs in the field of state law – albeit obedient to general guidance that will be determined in a federal complementary law, one which does not exist.

[15] *See* Hirschl, *supra* note 12, at 1343.

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continental dimensions, with complex federal systems. This includes several potential problems related to the implementation of policies at different levels.[16] No single metropolis dominates local governments in Brazil, with Brazilian urban centers being geographically spread out as in the United States.[17] There have been limited attempts in literature to assess design choices made by different federations.[18] [19] This study aims to reduce this gap and to mitigate the so-called parochialism in the current U.S. scholarship.[20] Moreover, classical studies of federalism draw comparisons between countries of the developed world, such as Australia, Canada, Switzerland, and the United States.[21] In this context, the comparison with Brazil brings a new perspective, especially because of Brazil's developing status.

The main contributions of this research to the literature are straightforward. First, this research advances the literature on constitutional design by focusing on local governments, while verifying if the absence of constitutional provisions pertaining to local governments, as it is the case of the U.S. Constitution, was, in fact, a failure of constitutional design relating to future matters.[22] Second, this research analyzes the consequences of the Brazilian constitutional design, which went further by securing a place for local governments as federal actors alongside the states and the federal

[16] For a discussion of the problems of implementation of federal level policies, see Hirschl, *supra* note 12 at 1344–45.

[17] *See* DAVID SAMUELS, *"Reinventing Local Government? Municipalities and Intergovernmental Relations in Democratic Brazil", in* DEMOCRATIC BRAZIL 77 (Peter R. Kingstone & Timothy J. Power eds., 2000).

[18] Note that we refer to academic studies – not to work from practicioners and judges.

[19] *See* CHOUDHRY & HUME, *supra* note 10, at 359.

[20] For an empirical study finding evidence of U.S. parochialism with regard to federalism scholarship, see Carol S. Weissert, *Beyond Marble Cakes and Picket Fences: What U.S. Federalism Scholars can Learn from Comparative Work*, 73 J. POLIT. 965, 967-68 (2011). Emphasizing, long ago, the necessity of further research about comparative constitutional law. *See also* Bruce Ackerman, *The Rise of the World Constitutionalism*, 83 V. L. REV. 771, 794 (1997).

[21] *See* CHOUDHRY & HUME, *supra* note 10, at 356.

[22] *See* Hirschl, *supra* note 12, at 1348. (The omission of local governments in the constitutional text was a failure of constitutional design regarding future matters.

> One among many manifestations of this problem in constitutional design is the silence of most pre-twentieth-century constitutions with respect to urbanization and the emergency of the megacity. Whereas principles of federalism in a two-layer system were usually set out, local government was often overlooked by constitutional framers . . . Because the city is not recognized as an autonomous constitutional entity, it is often not represented at pertinent public-policy bargaining forums . . . At the same time, because the megalopolis is home to so many people, it inevitably carries the brunt of governmental (in) action with respect to crime, poverty, homelessness, etc. Even more acute is the state of megacities in the developing world, where migration to the city and urban sprawl have long exceeded reasonable capacity.)

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union.[23] In this sense, this research fosters the debate about the U.S. federalism, while offering a perspective grounded in local government.[24]

In addition, this article is unique in its research, using annexation as a proxy for local governments' powers while looking at Supreme Court cases of constitutional review. From the constitutional review standpoint, the comparison pursued in this research illustrates the predominant conflicts among groups litigating in each country, offering evidence of what are the main issues being disputed in local spheres with regard to annexation. It also shows how each Supreme Court balances freedom of local governments and national interests.[25] Moreover, it is noteworthy that the study of constitutional review itself is relevant on account of its positive correlation with economic and political stability, which enhances business and economic growth.[26] Constitutional review contributes to stability and reassures parties and investors that, for instance, countracts shall be fulffilded. By authorizing independent courts to review potential abusive judicial decisions, executive or legislative enactments, constitutional review advances the rule of law. The more stable is a country, the more foreign investors will be interested in doing business there.

This paper is organized as follows. Sections II and III refer to the U.S. and Brazilian scenarios, respectively, discussing the most controversial topics regarding annexation in the decisions of the U.S. Supreme Court and those of the S.T.F.. Section IV discusses the research findings, focusing on fundamental rights and constitutional design. Section V concludes.

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[23] *See* CONSTITUIÇÃO FEDERAL [C.F.] art. 18 (Braz.). Note that this article, when referring to Brazilian municipalities, uses the term as a synonym to local government, because "municipality" is the only admissible local government under the Brazilian Constitution of 1988.

[24] *See* CHOUDHRY & HUME, *supra* note 10, at 377 (highlighting the incidental position of local governments in classical federalism, and the limited comparative studies).

[25] This research considers local government law from the perspective of national (federal laws) and subnational (state laws) determinations, but it does not address cities as international actors, i.e., the concept of cities as international. For such dimension, see Gerald E. Frug & David J. Barron, *International Local Government Law*, 38 URB. LAW. 1 (2006).

[26] *See* Rafael La Porta, Florencio Lopez-de-Silanes, Cristian Pop-Eleches & Andrei Shleifer, *Judicial Checks and Balances*, 112 J. POLIT. ECON. 445 (2004).

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2. THE UNITED STATES SCENARIO

This section focuses on the federalism issues that the U.S.S.C. has addressed when deciding matters related to the annexation of local governments.[27] It investigates the limits of annexation in state law enunciated by the Court, pertinent arguments relating to state powers, and how the highest court developed its interpretation over time.

This article turns to an analysis of the U.S. cases, which were classified according to the main issues involved in the litigation.[28] The cases of each set are grouped in chronological order, and the issues that address annexation were considered by preponderance in relation to other issues raised by the decisions[29] This division intends to facilitate further discussion. The annexation cases were assembled in the following five groups: police power of states over municipalities, succession of liability of counties, judicial review of state statute, general decisions about due process of law, and racial discrimination in connection with the right to vote.

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[27] This research is interested in the progression of the U.S. Supreme Court's dockets, encompassing all of the cases that met the search criteria further detailed, being systematic and coherent with the parameters used for the Brazilian S.T.F.. This study is a departure from the methodology based on the "most difficult cases," because a relevant part of it is to compare the dockets of both Supreme Courts. For a survey about studies using the approach of the "most difficult cases," see Ran Hirschl, *The Question of Case Selection in Comparative Constitutional Law,* 53 AM. J. COMP. L. 125 (2005).

[28] West Law and Lexis Advance were consulted in a detailed online research. Only the cases that appeared for both searches became part of the research cluster. Three searches were conducted, all of them combining annexation with municipality, county, and local government, respectively. Municipality, county, and local governments are the three most common denominations referring to local governments as translated to the Brazilian "municípios." After the pertinent exclusions, this research found thirty-one decisions based solely on the cases that appeared on both search tools of West Law and Lexis Research. Notwithstanding this number, this research further addresses two cases that are relevant (and that were cited by scholars in the field that are related to this federalism discussion, albeit not dealing with annexation directly). The final list of cases of the electronic search is consolidated in Table 1. This research is limited until February 2014 in order to permit all of the search mechanisms concerning Brazilian and U.S. cases to be updated.

[29] On the one hand, there were cases that did not appear in the search, because they did not address annexation; nevertheless this article comments on them for purposes of completeness. The two cases that are also discussed, because they refer to the application of the equal protection clause to states (despite not dealing with annexation, directly) are: *Avery v. Midlan County*, 390 U.S. 474 (1968); *Allegheny Pittsburgh Coal Co. v. County Comm'n.*, 488 U.S. 336 (1989). On the other hand, there were cases that appeared in the search, but they were excluded because they did not directly address annexation (or state and local government powers) in light of this specific form of boundary change. There were several instances where annexation was not used in accordance with the technical meaning object of this research, but as mere vernacular synonym of inclusion or addition. This research focuses on general-purpose local governments. All of the cases dealing with board of educations, special districts, and similar entities were excluded because municipalities in Brazil do not encompass them.

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The first set of cases addresses police powers of the state over municipalities. In the *Slaughter-House* cases, the U.S.S.C. held that the state had an exclusive right under its police power to determine the localities where slaughtering was allowed to occur.[30] The U.S.S.C. also found that the laws of the federal constitution (in particular, Thirteenth and Fourteenth Amendments) were not applicable.[31] There were, however, vigorous dissents.[32]

The *Slaughter-House* cases represent a pioneer effort to challenge the former understanding of the Court about federalism occurring for the first time after the enactment of the amendments of the Reconstruction.[33] Under the traditional (Founding) federalism, such monopoly remains within the purview of the state. After the Reconstruction era, there was a valid challenge, although the majority's decision denied the departure proposed by the plaintiffs.[34] The majority decision was criticized on the grounds that it ultimately made the Privileges or Immunities Clause meaningless.[35]

Another case dealing with the police powers arising out of the protection of health and morals was *Holden*, where the Court determined that state police power might validly limit the right of contract. For the Court, the sheriff of Salt Lake County was merely executing the state law.[36]

Holt considered the exercise of police powers outside the limits of the city of Tuscaloosa, Alabama.[37] The Court upheld a statute which expanded the city's police powers to residents within a three miles radius of the municipal corporate limits. For the U.S.S.C., the city's police powers were not in violation

[30] *Slaughter-House Cases*, 83 U.S. 36 (1872). Technically, this decision rejected the application of the Privileges and Immunity clause as well as the Equal Protection and Due Process contained in the Fourteenth Amendment. For a discussion of how the Court modified the interpretation regarding the latter, see ERWIN CHEMERINSKY, CONSTITUTIONAL LAW: PRINCIPLES AND POLICIES 494-98 (4th ed. 2006).

[31] For a review of previous cases securing state power to regulate domestic affairs (including local governments), and contending that the Fourteenth Amendments was not applicable, see RAUL BERGER, FEDERALISM: THE FOUNDERS' DESIGN 158-61 (1987).

[32] *Slaughter-House Cases*, 83 U.S. 36 (1872).

[33] *See* BRUCE ACKERMAN, WE THE PEOPLE: FOUNDATIONS 94 (1993).

[34] *Id.* at 95, 115 (contending that the Court refused to apply the Reconstructions amendments beyond the limited scope of race).

[35] *See* JOHN HART ELY, DEMOCRACY AND DISTRUST 22-23 (1980) (noting that the final decision made the Privileges or Immunities Clause meaningless, and emphasizing that the Court changed its opinion about the Equal Protection Clause from The Slaughter-House Cases, but it has not done so as to the Privileges or Immunities Clause).

[36] *See Holden v. Hardy*, 169 U.S. 366 (1898).

[37] *See Holt Civic Club v. City of Tuscaloosa*, 439 U.S. 60 (1978).

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of the understanding of "government without franchise being a fundamental violation of the Due Process Clause."[38]

The cases comprised in that first set address a core question of the U.S. federalism, namely, police powers. As a rule, protection of health and safety can be regulated by the state under its police powers. The *Slaughter House* cases confirmed so, at a time when freedom of contract was perceived as unlimited. *Holt* authorizes the city to exercise police powers even outside its borders, further blurring the division lines. It also provides an example of the geographical, economic, political, and social functions of the U.S. boundaries, which justified the expansion of police powers based on the effect that the lack of regulation could have within the boundaries of a city.

The second set of cases addresses the question of the succession of liability of counties. In *Commissioners of Laramie County*, the U.S.S.C. decided that absent a state constitution, the legislature has the power to reduce or enlarge the area of a county, whenever public necessity or convenience requires.[39] The Court specifically stressed that if part of the territory of a town and its inhabitants is separated by annexation to another town (or by creation of a new corporation), the former corporation retains all property, powers, rights, and privileges, remaining subject to all its obligations and duties, unless some new provision was made by the act authorizing the separation.[40]

With similar reasoning, the U.S.S.C. affirmed that new towns formed by annexation of parts of an old town remained severally liable for the bonds of

[38] "From a political science standpoint, appellants' suggestions may be sound, but this Court does not sit to determine whether Alabama has chosen the soundest or most practical form of internal government possible. *Authority to make those judgments resides in the state legislature, and Alabama citizens are free to urge their proposals to that body . . .* The Alabama Legislature could have decided that municipal corporations should have some measure of control over activities carried on just beyond their 'city limit' signs, *particularly since today's police jurisdiction may be tomorrow's annexation to the city proper.* Nor need the city's interests have been the only concern of the legislature when it enacted the police jurisdiction statutes. Urbanization of any area brings with it a number of individuals who long both for the quiet of suburban or country living and for the career opportunities offered by the city's working environment. Unincorporated communities like Holt dot the rim of most major population centers in Alabama and elsewhere, and state legislatures have a legitimate interest in seeing that this substantial segment of the population does not go without basic municipal services such as police, fire, and health protection." *Id* at 73-74 (dicta) (emphasis added). All the internal citations to cases hereinafter are omitted, unless stated differently.

[39] *See Comm'rs of Laramie Cty. v. Comm'rs of Albany Cty.*, 92 U.S. 307 (1875). This case was cited as precedent for *City of Worcester v. Worcester Consol. St. Ry. Co.*, 96 U.S. 539 , 548–49 (1905) ("The city is a creature of the State . . . A municipal corporation is not only a part of the State, but is a portion of its governmental power.").

[40] *See Comm'rs of Laramie Cty.*, 92 U.S. at 310–11.

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the dissolved town.[41] Therefore, when a municipal corporation is dissolved and a new corporation is created and predominantly composed of the same community, it becomes the successor of the old corporation, liable for its debts. The status of "being the same community" was defined as relating to the taxable property being substantially the same, and having the same purposes of the former municipal corporation. Further, the Court determined that the U.S. Constitution forbids any legislative enactment that withdraws or limits the remedies for the enforcement of obligations assumed by a municipal corporation, if no substantial equivalent is provided.[42]

In another decision, the U.S.S.C. held that, upon annexation, authorities of towns or villages who were previouslt entitled to receive contractual benefits from such entities will no longer receive. For the Court, the grant was nonexistent, because the underlying obligation no longer exists, with the ordinances of the city being extended over the territory immediately at the moment of the annexation.[43]

With regard to the annexation of a township to a city and the contractual expiration of reduced fairs, the U.S.S.C cited *Blair v. Chicago*, reiterating that grants must be interpreted strictly and with no contractual rights enlarged by implication. Moreover, it involved no violation of contractual obligations by the city or the taking of property without due process of law.[44] The U.S.S.C. later distinguished and reduced the scope of this interpretation by considering the facts underlying such a contract, ultimately determining that an extension of the diminished price would violate Article 1, § 10 of the Constitution and the general prohibition of states impairing the obligation of contracts.[45]

The second ensemble of decisions illustrates the interpretation of the Court regarding contractual claims modified due to annexation. The Court distinguished the annexation effects when considering bonds (which, as a rule, had to be honored by the new entity) from the general contractual benefits.

[41] *See Town of Mount Pleasant v. Beckwith*, 100 U.S. 514 (1879).
[42] *See Mobile v. Watson*, 116 U.S. 289 (1886).
[43] *See Blair v. City of Chicago*, 201 U.S. 400, 488-89 (1906).
[44] *See Detroit United Ry. v. Detroit*, 229 U.S. 39, 44 (1913).
[45] *See Detroit United Ry. v. Michigan*, 242 U.S. 238, 252-53 (1916).

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Those benefits should be interpreted as nonexistent after the annexation, if legal doubt existed. The Court considered values of morality and transparency, which should inform public actions, even when they occurred in the closest sphere to the public (local government).

In a third set of cases, classification was based primarily on the possibility of review by the judiciary of state statutes regarding annexation. The first case addressed procedures pertinent to annexation.[46] It considered the annexation of counties to the state of West Virginia after the Civil War, determining that such annexation was valid, provided that the counties' population voted for it in an election. The U.S.S.C. held that it had jurisdiction over the lawsuit between the new state of West Virginia and the state of Virginia, with allegations of fraud in the election not being relevant, to the extent that the governor had certified the annexation in good faith.[47]

In a different case, the decision affirmed that the validity of proceedings under a statute for the annexation of a territory to a city was a determination of judicial nature, not a matter solely of legislative cognizance.[48] The U.S.S.C. decided that, when the legislature acted validly in annexing new territory to a city, the jurisdiction of the Court was not dependent on the form that legislative action is expressed, but upon " its practical effect and operation as construed and applied by state court of last resort, and this irrespective of the process of reasoning by which the decision is reached, or the precise extent to which reliance is placed upon the subsequent legislation."[49]

Another matter concerns the annexation of federal territory by a city. In this regard, the U.S.S.C. previously stated that it has jurisdiction to decide the case. The majority of the justices decided that the tax income levied on employees of the federal plant was valid.[50]

In another decision addressing the relationship between federal law and state powers with the potential effect in annexation,[51] a unanimous Court

[46] *See Virginia v. West Virginia*, 78 U.S. 39 (1870).
[47] *Id.* at 62–63.
[48] *See Forsyth v. Hammon*, 166 U.S. 506, 515 (1897).
[49] *Detroit United Ry. v. Michigan*, 242 U.S. 238, 247 (1916).
[50] *See also Howard v. Comm'rs of Sinking Fund*, 344 U.S. 624 (1953).
[51] *See FTC v. Phoebe Putney Health Sys.*, 133 S. Ct. 1003 (2013) (not directly about annexation, but effects of this boundary change were considered in the rationale developed by the Court).

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declined to recognize state action immunity to a former state hospital purchased by the local government. For the Court, because this hospital was the only one in town, antitrust law did not authorize such immunity[52]. In a different context removed from annexation, but also referring to limits of state power, the Court determined that the Equal Protection Clause of the Fourteenth Amendment should apply to state action that selects the party for discriminatory treatment by subjecting the party to taxes not imposed on others in the same class.[53]

The cases of the third set are relevant because they reiterate the judicial review of state law regarding annexation. The first case, *Allegheny Pittsburgh Coal Co. v. Cty. Comm'r.*, stated that the political question doctrine does not preclude the Court from deciding claims that arise out of boundary disputes between states, even when such lines were determined in an agreement by both states and Congress.[54] It advanced the power of the governor over the counties that were present in the governor's state. The remaining cases emphasized that judicial review did not jeopardize separation of powers, a recurrent theme since *Marbury v. Madison*.[55] Considering, specifically, *FTC v. Phoebe Putney Health System*, the interpretation of the Court was consistent with the state action doctrine, which fosters federalism by reserving an area of state sovereignty.[56] The doctrine of state action considers that the government has to obey the Constitution, regardless of whether it resorted to a corporate form. Ultimately, the decision did not encompass the hospital within the public function exception.[57]

The fourth set of cases comprises alleged violations to the due process Clause protected by the Fourteenth Amendment. In the first case, the U.S.S.C. decided that there was no violation of federal law or the Constitution in a lawsuit arising out of an annexation case that plaintiffs argued had occurred in

[52] *Id.*
[53] *See Allegheny Pittsburgh Coal Co. v. Cty. Comm'r.*, 488 U.S. 336, 345-46 (1989).
[54] *See Virginia v. West Virginia*, 78 U.S. 39, 60-61 (1870).
[55] *Marbury v. Madison*, 5 U.S. 137 (1803).
[56] *See* ERWIN CHEMERINSKY, CONSTITUTIONAL LAW: PRINCIPLES AND POLICIES 513 (4th ed. 2006).
[57] The public function exception refers to services that have been traditionally within the exclusive prerogative of the government. For a complete review of the exceptions, see CHEMERINSKY, *supra* note 55, at 517–38 (noting that utility companies are not a public function). As such, the Constitution does not always have to apply. It is noteworthy that the so-called public function exception is quite complex. An in depth analysis of its impact its outside the scope of this article.

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violation of their due process of law.[58] The Court dismissed the case, noting that it had no jurisdiction because the claim did not show a real and substantial dispute with regard to the effect or construction of the Constitution, or under color of federal law. In another case, the Court ruled that the discrimination between individuals and corporations regarding the annexation to a city of lands held for agricultural purposes cannot be attacked as unconstitutional.[59] Hence, discrimination among agricultural lands and other lands considering the right of a city to annex them is not in violation of constitutional guaranties of due process Clause and equal protection of the laws because it is within the power of the state to classify objects of their legislation.[60]

Still considering annexation and potential violation of the due process clause of the Fourteenth Amendment, the U.S.S.C. held in *Hunter*:

> Municipal corporations are political subdivisions of the state, created as convenient agencies for exercising such of the governmental powers of the state as may be entrusted to them. For the purposes of executing these powers properly and efficiently they usually are given the power to acquire, hold, and manage personal and real property. The number, nature and duration of the powers conferred upon these corporations and the territory over which they shall be exercised rests in the absolute discretion of the State. . . . . In all these respects the state is supreme, and its legislative body, conforming its action to the State Constitution, may do as it will, unrestrained by any provision of the Constitution of the United States.[61]

[58] *See McCain v. Des Moines*, 174 U.S. 168 (1899) (emphasizing the existence of state constitution determining the issue, and the absence of violation to the U.S. Constitution).
[59] *See Clark v. Kansas City*, 176 U.S. 114 (1900).
[60] *Id.*
[61] *See Hunter v. City of Pittsburgh*, 207 U.S. 161, 178-79 (1907). It is noteworthy that state law provided for the annexation of cities, with the smaller being annexed to the larger. The majority of both cities approved the annexation, but the majority of voters in Allegheny (the smaller city) were opposed to the annexation. The lower courts and the U.S.S.C. affirmed the consolidation decree, also based on the nonexistence of a contract between the citizens and the city of Allegheny for a given taxation, which would be against the nature of municipal corporations. Moreover, the Court decided that there was no deprivation of property without the due process in light of the increased taxation applicable after the incorporation.

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Both cases in the fourth set deal with claims arising out of the Fourteenth Amendment, showing how restrictively the Court has interpreted them. Accordingly, municipalities were empowered through the interpretation developed by the Court, who understood them as extension of the states.

The fifth and final group of cases focuses on the decisions of the U.S.S.C. with regard to racial discrimination and the right to vote.[62] Chronologically, this study begins with *Gomillion*,[63] when the U.S.S.C., for the first time in the context of annexation cases, limited the absolute power of states conceived in *Hunter*.[64] The Court held:

> Thus, a correct reading of the seemingly unconfined dicta of *Hunter* and kindred cases is not that the State has plenary power to manipulate in every conceivable way, for every conceivable purpose, the affairs of its municipal corporations, but rather that the State's authority is unrestrained by the particular prohibitions of the Constitution considered in those cases.[65]

The U.S.S.C. further remarked that the Constitution limits legislative control of municipalities, as any state power.[66] This limitation warrants emphasis that in the excerpt above the Court made an analogy with contractual rights in order to secure the right to vote. The Court considered that the new boundaries were a violation to the Fifteenth Amendment, depriving the citizens of the right to

[62] For previous analysis of decisions about the right to vote in local elections, see Richard Briffault, *Who Rules at Home? One Person/One Vote and Local Governments*, 60 U. CHI. L. REV. 339 (1993).

[63] *See Gomillion v. Lightfoot*, 364 U.S. 339, 342 (1960).

> The complaint amply alleges a claim of racial discrimination. Against this claim, the respondents have never suggested . . . any countervailing municipal function which Act 140 is designed to serve. The respondents invoke generalities expressing the State's unrestricted power – unlimited, that is, by the U.S. Constitution – to establish, destroy, or reorganize by contraction or expansion its political subdivisions, to wit, cities, counties, and other local units. We freely recognize the breath and importance of this aspect of the State's political power. To exalt this power into an absolute is to misconceive the reach and rue of this Court's decisions in the leading case of *Hunter v. Pittsburgh*, and related cases relied upon by respondents.

The Court further stressed that *Lamarie* was authoritative only regarding the general nonexistence of a constitutionally protected obligation arising between a state and its subordinate governmental entities, exclusively as the result of their relationship. *See Gomillion,* 364 U.S. at 343.

[64] *See* Hunter, *supra* note 60 (holding that municipal corporations were merely political subdivisions of the state and created upon states' discretion).

[65] Gomillion, 364 U.S. at 344.

[66] *Id*. at 344–45.

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vote due to their race.[67] It reaffirmed that state power is immune to judicial review if such power was exercised completely within the domain of state interest. This is thus different from the case at bar, wherein the state power was used to circumvent a federally protected right.[68] In addition, in *Avery v. Midland County*, the Court stated that the Equal Protection Clause applies to the exercise of state power, regardless if it was directly exercised by the state or by a political subdivision.[69]

In another decision, the U.S.S.C. upheld the modifications of Virginia's reapportionment statute for elections of members of the House and Senate, which determined that legislative districts should not change. This would be the case, despite the modification of boundaries after annexation.[70] According to the majority opinion, the reapportion plan did not violate the Equal Protection Clause of the Fourteenth Amendment.[71] In another similar decision,

[67] *Id.* at 345–46.

> A statute which is alleged to have worked unconstitutional deprivations of petitioners' right is not immune to attack simply because the mechanism employed by the legislature is a redefinition of municipal boundaries. According to the allegations here made, the Alabama legislature has not merely redrawn the Tuskegee city limits with incidental inconvenience of the petitioners; it is more accurate to say that it has deprived the petitioners of the municipal franchise and consequent rights and to that end it has incidentally changed the city's boundaries. While in form this is merely an act redefining metes and bounds, if the allegations are established, the inescapable human effect of this essay in geometry and geography is to despoil colored citizens, and only colored citizens, of their therefore enjoyed voting rights.

Id. at 347.

[68] *Id.* at 347–48. The concurring opinion by Justice Whittaker located the federal protection right within the Equal Protection Clause of the Fourteenth Amendment. *Id*. at 349 (Whittaker, J., concurring).

[69] *Avery v. Midland Cty.*, 390 U.S. 474, 479 (1968). Importantly, this litigation was about an election for County Commissioners in Texas – not a direct annexation procedure, but it was included because it addressed annexation in dicta. It further stated that the Fourteenth Amendment guaranteed that citizens have equal representation in political subdivisions that exercised policy-making functions. *Id.* at 481.

[70] *See Mahan v. Howell*, 410 U.S. 315 (1973).

[71] The Court held that there was no violation of the principle of one person, one vote, because it understood the state's objective of preserving the integrity of political subdivision as rational, to the extent that it corroborated the legislative goal of facilitating enactments of statutes referring solely to local matters. *Id*. at 326–28. Nevertheless, Justice Brennan partially dissented, citing that the deviation of 16,4% between the most overrepresented and the most underrepresented legislative districts in a state's lower legislative house is constitutionally impermissible and cannot be justified on the ground that the state adhered to political subdivisions lines when designing the districts. *Id.* at 345–49 (Brennan, J., concurring in part and dissenting in part).

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the Court also found no violation of such clause, justifying its holding in *Hunter*.[72]

In *Perkins v. Matthews*, the U.S.S.C. considered violations to §5 of the Voting Rights Act of 1965 (42 U.S.C.S. §1973c) in the context of annexations and related changes to the boundaries of adjacent areas that aimed to expand the number of eligible voters. [73]

The U.S.S.C. further explained the meaning of §5 of the Voting Rights Act in *City of Richmond v. United States*, a lawsuit that arose out of a post-annexation statute that reduced the African American population by 10% in comparison with the pre-annexation electoral base.[74] *City of Richmond* was later used as precedent to validate other actions with similar impacts, despite not being related to annexation.[75]

In addition, the U.S.S.C. determined that it was necessary for political units of a state covered within the jurisdiction of the Voting Rights Act to comply with the mandatory preclearance procedures of §5 of the Act, holding

[72] For a case demonstrating a new county charter that required approval under New York law, by a referendum of separate majorities of the voters who lived in the city within the county, and of those who lived outside city boundaries, see *Town of Lockport v. Citizens for Cmty. Action at the Local Level, Inc.*, 430 U.S. 259 (1977).

[73] *Perkins v. Matthews*, 400 U. S. 379 (1971). The case arose out of a Mississippi's city statute changing the location of polls, modification of boundaries changes, among others, in an election for mayor and aldermen. It emphasized that the Voting Rights Act of 1965 covered the city. The U.S.S.C. further stresses that section five was conceived to address changes that hold a potential for racial discrimination in voting. *Id.* at 388 (citing *Gomillion v. Lightfoot*, 364 U.S. 339 (1960)).

[74] *City of Richmond v. United States*, 422 U.S. 358 (1975).

[75] *See United Jewish Org's., Inc. v. Carey*, 430 U.S. 144, 160 (1977).

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that the city failed to prove that there was no discrimination.[76] Along those lines, the Court determined that the new boundaries, resulting from two consolidations and one annexation in Texas,[77] were in violation of §5, due to insufficiently neutralizing the adverse impact on minority voting.[78]

In another landmark decision, the U.S.S.C. concluded that annexation of inhabited land by a municipality was also subject to the preclearance requirement of §5, because it constituted a change in the voting practices.[79] The Court also attended to the nonexistence of African Americans in the previous annexation configuration as not being relevant, because the impermissible purpose under §5 referred to contemporary and future circumstances.[80] In another case of reapportionment in the context of the Voting Rights Act, the Court ruled that the scheme was so irrational on its face that it could be understood solely as an effort to segregate districts on the basis of racial classifications.[81]

Notwithstanding the previous case law concerning the Voting Rights Act, the Court decided that the Act was not applicable to the changes made in

[76] *See City of Rome v. United States*, 446 U.S. 156 (1980). Technically, the annexations are in reference to elections for City Commission and Board of Education. The decision in *City of Rome* asserts: "Congress plainly intended that a voting practice not be pre-cleared unless *both* discriminatory purpose and effect are absent." *Id*. at 172 (emphasis in original).

> [T]he District Court properly concluded that these annexations must be scrutinized under the Voting Rights Act. *See Perkins v. Matthews*, 400 U.S., at 388-90. By substantially enlarging the city's number of white eligible voters without creating a corresponding increase in the number of Negroes [sic], the annexations reduced the importance of the votes of Negro [sic] citizens who resided within the pre-annexation boundaries of the city. In these circumstances, the city bore the burden of proving that its electoral system 'fairly reflects the strength of the Negro [sic] community as it exists after the annexations.' *City of Richmond v. United States*, 422 U.S. 358, at 371. The District Court's determination that the city failed to meet this burden of proof for City Commission elections was based on the presence of three vote-dilutive factors: the at-large electoral system, the residency requirement for officeholders, and the high degree of racial bloc voting. Particularly in light of the inadequate evidence introduced by the city, this determination cannot be considered to be clearly erroneous.

City of Rome, 446 U.S. at 187.

[77] *See City of Port Arthur v. United States*, 459 U.S. 159 (1982).

[78] *Id.* at 162. The Court considered two previous plans and related findings of their discriminatory effect in order to determine that the third plan at bar was also tainted. *Id* at 168.

[79] *See Pleasant Grove v. United States*, 479 U.S. 462, 467 (1987) (citing *City of Rome*, where the majority of the annexations were of vacant land).

[80] *Id*. at 471.

[81] *See Shaw v. Reno*, 509 U.S. 630, 640-52 (1993). This case does not encompass any annexation procedure directly, but it is included because the majority decided that appellants were able to state a cause of action (citing annexation in *dicta*), and the case appeared in our online search.

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the allocation of powers of the county commissions.[82] According to the majority of the U.S.S.C., §5 was applicable only to changes that affected voting, candidacy requirements and qualifications, or the composition of the electorate.[83]

In a case involving the dilution of votes of governing authorities of counties in Georgia,[84] the Court distinguished the application of §2 of the Voting Rights Act from §5.[85] In another case, the Court decided that there was no dilution of minority votes in a reapportionment plan from the Florida legislative.[86]

This research considered the decision of *Shelby v. Holder*, to the extent that the Court discussed the federalism pact in order to rule §4(b) of the Voting Rights Act unconstitutional.[87] According to the majority, the formula used in

[82] *See Presley v. Etowah Cty. Comm'n*, 502 U.S. 491 (1992).
[83] *Id.* at 501–09.
[84] *See Holder v. Hall*, 512 U.S. 874 (1994).
[85]

> Retrogression is not the inquiry in section 2 dilution cases (whether voting practice 'results in a denial or abridgement of the right of any citizen of the United States to vote on account of race or color'; . . . Plaintiffs could not establish a section 2 violation merely by showing that a challenged reapportionment or annexation, for example, involved a retrogressive effect on the political strength of a minority group'). Unlike in section 5 cases, therefore, a benchmark does not exist by definition in section 2 dilution cases. And as explained above, with some voting practices, there in fact may be no appropriate benchmark to determine if an existing voting practice is dilutive under section 2. For that reason, a voting practice that is subject to the preclearance requirements of section 5 is subject to the preclearance requirements of section 5 is not necessarily subject to a dilution challenge under section 2.

Id. at 884-85.
[86] *See Johnson v. De Grandy*, 512 U.S. 997, 1019 (1994) (emphasizing that *Richmond v. United States* referred to territorial annexation designed to dilute African American votes was forbidden by section five of the VRA, regardless of its actual effect).
[87] *See Shelby Cty. v. Holder*, 133 S. Ct. 2612 (2013).

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the Act was forty years old and no longer reflected the realities in the states covered by it.[88] The U.S.S.C. asserted:

> The Voting Rights Act of 1965 employed extraordinary measures to address an extraordinary problem. Section five of the Act required States to obtain federal permission before enacting any law related to voting—a drastic departure from basic principles of federalism. And section four of the Act applied that requirement only to some States—an equally dramatic departure from the principle that all States enjoy equal sovereignty. This was strong medicine, but Congress determined it was needed to address entrenched racial discrimination in voting. As we explained in upholding the law, "exceptional conditions can justify legislative measures not otherwise appropriate."[89]

In light of U.S. federalism, the Court explained that the federal government is not generally authorized to review and veto state enactments before they go into effect. This is true despite such power being considered at the time of the Convention, anddenied in favor of the Supremacy Clause and related potential challenges occurring after the effect of state law.[90] Also, the Court reaffirmed that the Tenth Amendment grants to the states all the powers not specifically granted to the federal government, and that " not only do States retain sovereignty under the Constitution, there is also a 'fundamental principle of equal sovereignty' among the States."[91] The dissenting opinion justified the

[88] The decision emphasizes that African American voter turnout actually increased in five of the six states originally covered by the VRA, of 1965. *Id*. at 2619. Shelby County is located in Alabama. The following states were originally covered by section five: Alabama, Georgia, Louisiana, Mississippi, South Carolina and Virginia. Arizona and Texas were included in 1972, also in their totality. The majority of the Court noted in *Shelby* that by 1965 the Act divided the states among those which have literacy tests (coupled with low voter registration and turn out) and those which did not; nowadays, for the Court: "the Nation is no longer divided along those lines, yet the Voting Rights Act continue to treat it as if it were." *Id*. at 2628. At the time of the *Shelby* decision, Florida, New York, North Carolina, South Dakota and Michigan were partially included, according to data from the Department of Justice of the United States. There is no information available with regard to the current jurisdictions covered after *Shelby* (and its potential bail out effect). *Jurisdictions Previously Covered By Section 5*, U.S. DEPARTMENT OF JUSTICE (last updated Aug. 6, 2015), http://www.justice.gov/crt/about/vot/sec_5/covered.php.

[89] *Shelby Cty.*, 113 S. Ct. at 2618.

[90] *Id.* at 2623.

[91] *Id.*

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exceptions based on the remaining necessity of differentiated treatments for the states mentioned in the Act.[92]

The majority holding in *Shelby* can be understood as being aligned with the current trend of using tradition to limit the judicial review of the democratic process at state and local levels.[93] Nevertheless, tradition itself has been subject to criticism, because the U.S. experience is founded on multiple traditions.[94] In addition, the assurance of the legislative representation of minorities remained the core of the Act, and it is unclear, as of today, how the decision of the Court affects those to whom the protection was designed.[95]

Still considering the *Shelby* decision, a related topic of particular interest for this comparison with Brazil is the fact that the U.S.S.C. determined that Congress did not act –or did not consider doing so – despite the warning given by the U.S.S.C. in a decision dating back to 2009, determining that the formula of §2 must be updated.[96]

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[92] The dissent opinion written by Justice Ginsburg – joined by Justices Breyer, Sotomayor and Kagan – specifically addresses annexation as a form of discrimination in different passages where it was emphasized that Pleasant Grove, a city in a neighbor county of Shelby, acted with purposeful discrimination when annexing all white areas and denying the annexation request of an adjacent black neighborhood. *Id*. at 2535, 2646 (Ginsburg, J., dissenting) (citing *Pleasant Grove v. United States*, 479 U.S. 462 (1987)).

[93] *See* CASS R. SUNSTEIN, DESIGNING DEMOCRACY: WHAT CONSTITUTIONS DO? 80-81 (2001) (arguing as potential explanations for such approach as follows: the fact that the U.S. Constitution is better understood for the Court if being preservative, and that the due process clause is better interpreted in a very restrictive form. According to the author, both understandings would reduce the Court's discretion).

[94] *Id*. at 82–87 (criticizing the use of tradition regarding race).

[95] *See* DONALD HOROWITZ, *Constitutional Design: Proposals versus process*, *in* THE ARCHITECTURE OF DEMOCRACY: CONSTITUTIONAL DESIGN, CONFLICT MANAGEMENT AND DEMOCRACY 19 (Andrew Reynolds ed., 2002).

[96] *Shelby*, 113 S. Ct. at 2615 (referring to *Nw. Austin Mun. Utils. No. One v. Holder*, 557 U.S. 193 (2009)). The *Shelby* decision emphasizes that Congress could have updated such formula when it extended the Voting Rights Act of 1965 through its reauthorization in 2006. *Id*. The Court stated:

> Our decision in no way affects the permanent, nationwide ban on racial discrimination in voting found in section two. We issue no holding on section five itself, only on the coverage formula. Congress may draft another formula based on current conditions. Such a formula is an initial prerequisite to a determination that exceptional conditions still exist justifying such an 'extraordinary departure from the traditional course of relations between the States and the Federal Government.

Presley v. Etowah Cty. Comm'n, 502 U.S. 491, 500-01 (1992). "Our country has changed, and while any racial discrimination in voting is too much, Congress must ensure that the legislation it passes to remedy that problem speaks to current conditions." *Id.* at 2631. The dissent opinion vehemently criticizes such an understanding. *Id*. at 2632-33 (Ginsburg, J., dissenting).

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3. THE BRAZILIAN SCENARIO

Brazilian re-democratization process started in 1979, with the appointment of the moderate military João Figueiredo as President, leading to the gradual ending of the overcentralized military ruling. In 1982, the first direct election for governors since the 1964 coup d'état was held.[97] After a long deliberation,[98] the Constitution of the Brazilian Republic was approved on October 5, 1988 by a Constitutional Convention that included federal congressional representatives (deputies) and senators.[99] Mayors and governors were among the most powerful actors in lobbying for decentralization, fomenting a constitutional order that became a "center-constraining federation unprecedented in Brazilian history."[100]

In light of the above, Brazilian federalism has shown complex dynamics.[101] The President needs to engage in as many coalitions of political parties as possible, while reconciling local and regional demands that dominate each party.[102] Accordingly, national interests are often belittled if conflicting with state or local demands. In this scenario, the ongoing constitutional amendments impacting local governments and political scandals involving Presidents loomed in the background as the S.T.F. decided the cases in our

[97] For information concerning Brazilian elections for state governors, federal deputies, and senators from 1945 until 1990, see *Brazilian Superior Tribunal for Electoral Law*, TSE (Feb. 20, 2015), http://www.tse.jus.br/eleicoes/eleitos-1945-1990/cronologia-das-eleicoes. Direct elections brought a "dramatic change in the executive-legislative relations (even though a military President remained in office until 1985)," because democratic state elections pressured the President and ultimately leaded to state governors conquering more decentralization of revenues. SAMUELS, *supra* note 17, at 169

[98] The Constitutional Convention met between February 1987 until September of 1988. The Brazilian Constitutional Convention was not elected nor formed by delegates directly elected to write the Constitutional text itself, due to a compromise during the transition period from the military ruling to democracy. CLÁUDIO PEREIRA DE SOUZA NETO & DANIEL SARMENTO, DIREITO CONSTITUCIONAL: TEORIA, HISTÓRIA E MÉTODOS DE TRABALHO 156 (2013).

[99] The less populated states of North and Center West were favored in the unbalanced representation of their states' senators in the Convention, because all states are have equal representation in the Brazilian Senate. The non-updated number of federal deputies per state (disregarding population growth in the Southeast) also disfavored the southeast states, see SOUZA NETO & SARMENTO, *supra* note 97, at 160.

[100] Celina Souza, *Brazil: The Prospects of a Center-Constraining Federation in a Fragmented Polity*, 32 PUBLIUS., 23, 31 (2002). It is noteworthy that Brazil has had lasting periods with state governors being very empowered, such as during the so-called Old Republic.

[101] Local forces have long united forces with their respective state authority to pressure the federal government. The local authority is very empowered. A classical reference on this understanding and peculiarities that impact federalism, see VICTOR NUNES LEAL, CORONELISMO, ENXADA E VOTO: O MUNICÍPIO E O REGIME REPRESENTATIVO NO BRASIL (7th ed., 2012).

[102] SCOTT MAINWARING, *Multipartism, Robust Federalism, and Federalism in Brazil*, *in* PRESIDENTIALISM AND DEMOCRACY IN LATIN AMERICA 83-4 (Scott Mainwaring & Matthew Soberg Shugart eds., 1999).

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dataset. And, as any Supreme Court in the world, the S.T.F. has to consider its own political capital and incentives for compliance by the involved parties.

This research is limited to the decisions that occurred during the Constitution of 1988 until February of 2014.[103] The reasons for choosing this time period are threefold. First, the Constitution of 1988 modernized the Brazilian tradition, as previously mentioned, by elevating municipalities to the status of federal actors (with states and the federal union). Second, the Constitution of 1988 technically ended the transition phase from the end of the military regime (1985) to democracy. Third, new constitutions are most susceptible to risk of replacement within their first nineteen years.[104] Consequently, this study covers a temporal duration greater than this critical period.[105]

With regard to the composition of the lawsuits, this dataset indicates that the S.T.F. was not called upon to decide cases involving fundamental rights.[106] The issues at bar relate to the application (including clarification) of the objective constitutional requirements of annexation. It is worth noting that the U.S. concept of annexation is equivalent, in practice, to the concept of "dismemberment through annexation" in the Brazilian constitutional text. According to this Brazilian modality, both municipalities remain in existence.[107] The regions that presented a highest number of lawsuits were the Northeast (mainly due to the federative state of Bahía) and the Center West (because of Mato Grosso).[108]

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[103] This search was conducted using the website of the S.T.F.: *Pesquisa de Jurisprudência*, SUPREMO TRIBUNAL FEDERAL, http://www.stf.jus.br/portal/jurisprudencia/pesquisarJurisprudencia.asp (last visited Aug. 4, 2016). Table 2 contains the final decisions of the S.T.F.. No singular or panel decisions were considered, because only the Court *en banc* has jurisdiction to decide a unique and novel constitutional question or to departure from previous case law.

[104] *See* ZACHARY ELKINS, TOM GINSBURG & JAMES MELTON, THE ENDURANCE OF NATIONAL CONSTITUTIONS 129 (2009).

[105] Establishment, merger, fusion, and dismemberment of municipalities appeared together in the search mechanisms of the S.T.F., due to the writing of the constitutional provisions and the less technical terminology used by litigants. After the appropriate exclusions (mainly referring to annexation as a term of commercial law), this research analyzed sixteen decisions (*see* tbl 2).

[106] *See* Chart 2, which illustrates the lawsuits over time.

[107] For detailed definitions of dismemberment in the context of state law see ALEXANDRE DE MORAES, DIREITO CONSTITUCIONAL 308-10 (28th ed., 2009).

[108] Bahía is the third state in number of municipalities. Mato Grosso is within the national average. *Notícias*, SENADO FEDERAL, http://www12.senado.gov.br/noticias/entenda-o-assunto/municipios-brasileiros (last visited on August 4, 2016).

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Concerning the dynamics of the federative pact, we note that the vast majority of the Adins were started either by the Attorney General of the Republic or by national parties.[109] The direct board of a legislative assembly of a state filed only one Adin.[110] Hence, the litigation became a national one, as it was no longer limited to the local level.

At this point, the focus is the legal issues decided. The Court declined to rule on the constitutionality of a resolution for the state assembly of the state of Rio de Janeiro.[111] It specified that for the annexation of municipality, the previous plebiscite must occur in accordance with the federal Constitution, while declaring that the municipality was also a creature of the member state.

After the Constitutional Amendment 15/96, the S.T.F. determined that all the procedures referring to municipal boundary changes must be suspended until the federal complementary law was approved.[112] The Court also distinguished the municipality as autonomous under article 18 of the Constitution. In this decision, the S.T.F. stressed that municipalities could no longer be matters of the private interest of the state, as in previous Constitutions.[113] The S.T.F. also dismissed allegations attacking the constitutionality of the Constitutional Amendment 15. Those allegations were based in an arguable violation of the federative pact in which protection is granted among the immutable clauses of the Constitution (article 60, paragraph 4, I).[114] The S.T.F. decided that Amendment 15/96 did not violate the essential nucleus of the autonomy of the member states when the amendment was modified from state complementary law to federal law.

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[109] The Attorney General of the Republic filed the following ten Adins: ADI 1372 MC/RJ; ADI 1373 MC/PR; ADI 2702/PA; ADI 2632/BA; ADI2994/BA; ADI 3149/SC; ADI 3489/SC; ADI 3316/MT; ADI 3682/MT; and ADI 4992 MC/RO. Political parties initiated five Adins: ADI 2381MC/RS; ADI 2632MC/BA; ADI 3615/PB; ADI 2240/BA; ADI 3689/PA.

[110] *See* ADI 2395 /DF.

[111] *See* ADI 1372 MC/RJ, of 1995. Also determining that the plebiscite must occur before the changes in the municipal boundaries: ADI 1373 MC/PR, of 1995.Attention should be given to the fact that those decisions occurred prior to the Constitutional Amendment 15/1996. Although, the necessity of previous plebiscite has been maintained by the amended text.

[112] *See* ADI 2381 MC/RS, of 2001.

[113] The leading case is the ADI 3682/MT, of May 05, 2007, when the S.T.F. considered that after eleven years after the Constitutional Amendment 15, of 1996, it was unreasonable for Congress to not have promulgated the federal complementary law, despite several legislative proposals. Neither the House nor the Senate actually discussed (let alone voted) the federal complementary law. GILMAR FERRREIRA MENDES & PAULO GUSTAVO GONET BRANCO, CURSO DE DIREITO CONSTITUCIONAL 1160 (8th ed., 2013).

[114] In this direction: ADI 2381 MC/RS, of 2001; ADI 2395/DF, of 2007.

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Several later decisions required that the modifications of municipal boundaries could only be valid if two conditons were met. First, the promulgation of federal complementary law and, second, previous approval by plebiscite of the involved population.[115]

The change of paradigm in the understanding by the S.T.F. occurred in 2007, when the Court judged several direct actions of unconstitutionality on the same date, despite those actions presented different justices as rapporteurs (reporters).[116] Importantly, further decisions reiterated the new position of the Court.[117]

The most recent decisions of the S.T.F. still deny annexation of municipalities when based on state laws, if those boundary changes were enacted after the Constitutional Amendment 57/2008. The Court stressed that the Constitutional Amendment 57, modifying the Act of Transitory Dispositions of the Constitution, validated solely the boundary changes enacted by municipalities between the Constitutional Amendment 15/96, and December of 2006.[118] Accordingly, the Court interpreted the modification of the Transitory Acts quite literally, and as restrictively as possible, in order to protect the constitutional order as a whole.The Court was mindful of potential discontinuity of the legal order and related uncertainties.

This study contends that local actors in Brazil must be restrained and act in accordance with constitutional commands. This recommended course of action consists in obeying the S.T.F. and refraining from annexing municipalities in the absence of the pertinent federal complementary law. It also consists of complying with specific constitutional principles of legality,

[115] In the same vein: ADI 2632 MC/BA, of 2002 (*in limine*, i.e., by injunction); ADI 2702/PR, of 2003; ADI 2632/BA, of 2004 (final decision); ADI 2994/BA, of 2004, ADI 3149/SC, of 2004; and ADI 3615/PB, of 2006.

[116] ADI 2240/BA, of May, 5 2007, whose rapporteur was Justice Eros Grau, granted twenty-four months for the Congress to legislate. ADI 3489/SC was also judged on the same day and with the same rapporteur, but it determined eighteen months for Congress to act. All of the decisions were unanimous, concerning as matters of unconstitutionality, although the majority decided as to the unconstitutionality of the boundaries change. Another case decided on the same date and with Justice Eros Grau as rapporteur, but establishing eighteen months: ADI 3316/MT. In the direct action of unconstitutionality by omission, ADI 3682/ MT, from the same date, but having as rapporteur Justice Gilmar Mendes, it was emphasized that the inaction of Congress was unconstitutional and that the twenty-four months deadline did not refer to Congress to act; it referred solely to the state laws altering the boundaries of the municipalities to remain valid.

[117] *See* ADI 3689/PA, of 2007.

[118] *See* ADI 4992 MC/RO, of 2013.

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efficiency and morality, which are mandatory to all public administration.[119] Those principles will support informed conduct, including detailed assessment of the financial feasibility of annexation. Therefore, local forces cannot remain unchecked, with the municipal boundaries being altered in a clear violation of the constitutional order.

4. DISCUSSION OF RESEARCH FINDINGS

This section is divided into two subsections. Subsection A focuses on the general analysis of the comparison, including fundamental rights. Subsection B discusses the impact of these findings based on constitutional design. The decisions of both Supreme Courts were approached with no preconceptions.

4.1. GENERAL ANALYSIS OF THE COMPARISON AND RELATED CONSEQUENCES FOR FUNDAMENTAL RIGHTS

This research considers annexation as proxy for local powers in two distinguished constitutional experiences. Our findings validate the claim that local governments are more empowered in the United States in light of the reduced number of national litigation in the U.S.S.C.. The decisions of the S.T.F. are higher in relative numbers, while presenting limited subject matters in comparison with the decisions of the U.S.S.C.. The first explanation refers to the period of time, since the analyzed U.S. decisions date back to the inception of the Constitution. Having thirty-one annexation cases in our dataset (and considering that the U.S. Constitution was signed in 1787) does not corroborate the understanding that the absence of local governments in this founding document is necessarily negative.[120] There is no evidence that the absence of constitutional provisions about local governments nowadays contributes to an increase of litigation. Remarkably, the bulk of U.S. litigation analyzed in the

[119] *See* CONSTITUIÇÃO FEDERAL [C.F.] art. 37 (Braz.).
[120] *See* Hirschl, *supra* note 12, at 1348.

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context of annexation has been after the Voting Rights Act of 1965.[121] If such cases were to be disregarded, the number of litigation in both courts is almost the same (twenty in the United States versus sixteen cases in Brazil).[122] This occurs, despite the U.S. Constitution being largely the same document, since 1787.[123]

In the United States, annexation varies across states.[124] Race and class biases are present in annexation, reflecting seminal conflicts relating to property rights and redistribution.[125] The core of U.S.S.C. decisions referring to annexation address questions of exclusion. In this sense, the cases in our dataset corroborate the view that boundaries of a municipality carry a remarkable exclusionary function, which determines who is entitled to participate in the redistribution of the resources in a given community.[126]

In Brazil, however, demographic exclusions occur on account of a lack of resources. This research corroborates previous claims for the general creation of a national level policy in Brazil. The current chaos of decentralization enhances inequalities among Brazilian regions, neglecting the poorest segments of society.[127] Debates pertinent to local interests tend to be far from the citizen with a different experience than traditional portrays typical of the United States.

Comparative constitutional law is concerned with the existence and scope of Bill of Rights provisions.[128] As the U.S.S.C. decisions demonstrate, those provisions are necessary for the protection of rights and the rule of law. Our dataset indicates how the issues judged by the U.S.S.C. evolved. Initially, the Court was mainly focused on patrimonial disputes. After the enactment of

[121] For a complete list of the cases, year, and main issues discussed by the U.S.S.C. and the S.T.F., *see* tbl.1 and 2, respectively.
[122] Chart 1 illustrates the comparison between the decisions of the U.S.S.C. (from 1870 until 2014) and the Brazilian S.T.F. (from 1988, when the Constitution inaugurated the inclusion of municipalities in the federal pact, until 2014).
[123] For arguments claiming that the interpretation of the U.S.S.C. amounted to a complete new Constitution despite the text remaining the same during the New Deal, see ACKERMAN, *supra* note 33, at 58-80.
[124] *See* Robert D. Zeinemann, *Overlooked Linkages Between Municipal Incorporation and Annexation Laws: An In-depth Look at Wisconsin's Experience*, 39 URB. LAW. 257, 311 (2007).
[125] *See* Tyson, *supra* note 2, at 519.
[126] *Id.*
[127] *See* SAMUELS, *supra* note 17, at 96.
[128] *See* SUJIT CHOUDHRY, *Bridging Comparative Politics and Comparative Constitutional Law*, *in* CONSTITUTIONAL DESIGN FOR DIVIDED SOCIETIES 9-13 (2008).

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the Voting Registration Act, of 1965, its docket radically changed. The U.S.S.C. became particularly concerned with asserting the effectiveness of federal rights. The docket also shows different actors from previous years. This occurred because the states mentioned in the Act became an object of intense litigation. Regarding the protection of rights, research findings demonstrate that this protection has increased after World War II, as the importance of constitutional adjudication increased to protect minorities.[129]

The S.T.F. decisions protect the rule of law, but do not prove to be supportive of any fundamental rights protection. This is different from what was expected, because the S.T.F. carried a long tradition of fundamental rights protection.[130] After two constitutional amendments and radical modifications in the case law of the S.T.F., Brazil remains in a grey area, in practice and legal matters. Therefore, municipalities were not necessarily more empowered simply by virtue of their inclusion in the Brazilian Constitution. In this sense, the federal pact chosen was not capable of continuing as initially planned. Despite warnings by the S.T.F., local actors are, de facto, annexing cities without the existence of federal complementary law.[131]

Importantly, this study's results validate Shapiro and Stone Sweet's hypothesis of the expansionary role of courts for protecting rights.[132] The U.S.S.C. and the S.T.F. expanded their roles from the traditional and very restrictive separation of powers doctrine. Hence, both courts shifted the lines from what may be regarded previously as a clear separation. The U.S.S.C. accomplished this task by reviewing its initial interpretation of the Fourteenth

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[129] *See* CHARLES R. EPP, THE RIGHTS REVOLUTION: LAWYERS, ACTIVISTS AND SUPREME COURTS IN COMPARATIVE PERSPECTIVE 38-39 (1998) (noting that the increased presence of cases involving the due process clause and equality began 1918 (after the World War I), but the U.S.S.C. rejected such claims until the 1960s).

[130] Historically, the S.T.F. remains protective of fundamental rights, including the time of the military ruling. *See* MATTHEW M. TAYLOR, JUDGING POLICY: COURTS AND POLICY REFORM IN DEMOCRATIC BRAZIL 34-35 (2008).

[131] Research findings are consistent with the balanced role played by the S.T.F. in the transition to democracy. *See e.g.* DIANA KAPISZEWSKI, HIGH COURTS AND ECONOMIC GOVERNANCE IN ARGENTINA AND BRAZIL 207 (2012).

[132]

> [T]he more judges consider effective rights protection to be their constitutional duty. . . . the less likely judicial review will conform to, or be contained by, separation of powers doctrines. . . . in systems in which the supremacy of the constitutional law within the general hierarchy of norms is defended by a authority, all separation of powers notions are contingent because they are secondary to, rather than constitutive of, judicial function.

MARTIN SHAPIRO & ALEC STONE SWEET, ON LAW, POLITICS & JUDICIALIZATION 364 (2011).

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Amendment, extending the prohibition of discrimination to states, and by upholding the constitutionality of the Voting Rights Act at least for several years until the *Shelby* decision (2013). The S.T.F., on its turn and in a bold movement, declared the unconstitutionality of the Congressional enactment of the federal complementary law, defining the general requirements for the annexation of municipalities.

4.2. INSIGHTS BASED ON CONSTITUTIONAL DESIGN

Constitutional clauses determining competences, powers, and structures of the government are perceived with less enthusiasm than provisions of rights.[133] The role of the U.S.S.C. as a safeguard of federalism was questioned recently.[134] Federalism and judicial review are often named along the structural provisions of the U.S. Constitution that have been very influential abroad.[135] This research considers the different federal experiences of the United States and Brazil.

Since its inception in the U.S. constitutional scheme, federalism remains a complex concept.[136] Federalism is traditionally defined as an arrangement in which a written constitution expressly determines powers of the central and regional spheres of governments, with direct elections for national and regional governments. Additionally, in this way, distinguished spheres of government act independently from each other, and a high court remains independent to decide on matters of conflict among them.[137] Federalism is, therefore, a response to concrete political tensions. It is often addressed among constitutional design choices that impact power sharing, including the participation of representatives of the relevant groups of society

[133] *See* Günter Frankenberg, *Comparing Constitutions,* 4 INT'L. J. CONSTIT. L. 439, 455-56 (2006) (emphasizing the reduced appeal of constitutional provisions about political organization as an object of comparative constitutional law).
[134] *See* Carol S. Weissert, *Beyond Marble Cakes and Picket Fences: What U.S. Federalism Scholars can Learn from Comparative Work*, 73 J. POLIT. 965, 968 (2011) (acknowledging the existence of the debate in the U.S. constitutional scheme).
[135] *See* David S. Law & Mila Versteeg, *The Declining Influence of the United States Constitution*, 87 N.Y.U. L. REV. 762, 785 (2012).
[136] *See* G. EDWARD WHITE, THE AMERICAN JUDICIAL TRADITION: PROFILES OF LEADING AMERICAN JUDGES 19 (2006).
[137] *See* For the specific definition of classical federalism, see CHOUDHRY & HUME, *supra* note 10, at 357.

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in political decision-making.[138] The absence of constitutional provisions pertaining to local governments was recognized as a failure of constitutional design relating to future matters.[139]

In the United States, cities only have the powers that were delegated to them by states and that were not limited by judicial interpretation.[140] Municipalities' power to tax is significantly constrained by state rules and the Commerce Clause.[141] In this sense, the choice of locating cities as subordinated to states was adopted in view of the federal system.[142] It was based on an assumption that, had it been different, the unified political system under the Constitution would have been jeopardized.[143]

As previously explained, annexation in the United States is defined by state laws. According to principles of constitutional law, Congress may act when (implied or express) authorization exists in the Constitution.[144] In this context, powers not granted to the national government are reserved for the states. The states did not grant the federal government authority to modify municipal boundaries, and state legislatures may directly alter municipal boundaries or establish procedures that local governments must obey when altering them.[145] As such, there is no uniform national law regulating annexation, illustrating the self-determination of the states. Based on evidence provided by this research, general-purpose local governments in the United

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[138] *See* Arend Lijphart, *Constitutional Design for Divided Societies*, 15 J. DEMOCR. 96, 97 (2004) (articulating the concept of power sharing).

[139] *See* Hirschl, *supra* note 12, at 1348. In addition, article V of the U.S. Constitution, with its rigidity towards amendments, was perceived as greatly condescending to state powers while being too hostile to local interests. Aziz Z. Huq, *The Function of Article V*, 162 U. PA. L. REV. 1165, 1187 (2014).

[140] *See* Gerald Frug, *The City as a Legal Concept*, 93 HARV. L. REV. 1059, 1062 (1980).

[141] On the general constraints imposed by state powers and by the Commerce Clause, *see, id.*, at 1064 (emphasizing that the abilities of cities to borrow money suffered even stronger limitations). The author remarks that even in "home rule" states (i.e., where powers of purely local matter would be granted to cities), state law considers cities as "creatures of the state". *Id.* at 1063 (*quoting Hunter v. City of Pittsburgh*, 207 U.S. 161 (1907)).

[142] *Id.* at 1065–67 (outlining the consequences of locating municipalities as forbidden to exercises of general governmental power, while not capable of freedom granted to private corporations).

[143] *Id.* at 1106. *See also*, ROBERT A. DAHL, HOW DEMOCRATIC IS THE AMERICAN CONSTITUTION? 12 (2001) (noting that the states would encompass the federation (and that the unitary government was excluded, due to historical experiences present at the time of the Framers), and contending that the only question at the Convention in that regard was how much autonomy to confer to the central government).

[144] *See* CHEMERINSKY, *supra* note 56, at 234.

[145] *See* GREY LINDSEY, *Annexation Activity and Policy in the US*, *in* REDRAWING LOCAL GOVERNMENT BOUNDARIES: AND INTERNATIONAL STUDY OF POLITICS, PROCEDURES AND DECISIONS 56 (John Meligrana ed., 2004).

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States are more powerful than those in Brazil. This claim is supported by the fact that United States local governments are capable of defining their own boundary limits in general, without interference from the federal union. States in Brazil have a mitigated version of self-determination, being subject to a uniform national procedure.

Importantly, the Brazilian Constitution explicitly determines that the S.T.F. has the duty to safeguard the Constitution, and federalism is listed among the so-called constitutional immutable clauses.[146] In Brazil, local governments were conceived as federal actors, with much financial autonomy being granted. Hence, there is an interest in creating and annexing municipalities in order to receive such revenues but not necessarily in excluding particular citizens, as it has occurred in annexations in the United States.[147]

Urbanization and the politics of the military ruling are relevant factors for explaining the Brazilian departure of comparative constitutional design, with Brazilians writing their own peculiar federalism pact.[148] Brazil's increased number of municipalities supports the understanding that in federal systems where units are heterogeneous, politicians have higher incentives to cooperate with each other at the local spheres, before working on the central level.[149] This is particularly relevant in the Brazilian context, where municipalities have weak ties with their own state.[150] In addition, municipalities had secured financial autonomy and revenue levies in an unprecedented fashion.[151] The

[146] CONSTITUIÇÃO FEDERAL [C.F.] c. I, art. 60, para. 4; art. 102 (Braz.).
[147] *See* SAMUELS, *supra* note 17, at 98.
[148] Brazil borrowed several constitutional provisions from the U.S. experience, such as: the nomination of S.T.F. justices, the residual powers of states if the Constitution is silent, mechanisms authorizing judicial review on the state level, among others. Hence, the fact that Brazil decided not to borrow the absence of local governments provisions indicate the degree to which local actors wielded power at the time. For explanations on why borrowing may not occur due to political factors, see Lee Epstein & Jack Knight, *Constitutional Borrowing and Nonborrowing*, 1 I-CON, INT'L. J. CONSTIT. L. 196, 200 (2003).
[149] *See e.g.* HOROWITZ, *supra* note 95, at 25 (arguing such advantage for federal systems that are heterogeneous).
[150] LUIZ CESAR DE QUEIROZ RIBEIRO & SOL GARSON BRAULE PINTO, LOCAL GOVERNMENT AND METROPOLITAN REGIONS IN FEDERAL SYSTEMS: A GLOBAL DESIGN ON FEDERALISM 75 (Nico Steytler ed., 6th ed. 2006).
[151] The Brazilian Constitution established a complex system of revenues for municipalities. CONSTITUIÇÃO FEDERAL [C.F.] [CONSTITUTION] art. 156 (Braz.) (outlining exclusive municipal taxes); art. 158 (determines municipal revenue sharing); art. 159 (supplements mandatory transfers from federal union); art. 153, para. 5 (secures more revenues for municipalities). The current Constitution significantly reduced federal revenues from the union, and that change of revenues toward states and municipalities was not accompanied by administrative responsibilities, which

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decentralization implemented by the constitutional text, with municipal revenue sharing, brought significance to the "elevation of municipalities to separate federal status" under the Constitution of 1988.[152] The Brazilian experience is remarkably different from the U.S. design. The Constitution of 1988 is the only one to expressly locate municipalities accompanying the federal union and states as members of the federation.[153] Hence, the residual powers of the Brazilian states are defined as those not granted to the federal union as well as the powers that were not conferred to municipalities.[154]

In this scenario, once the original scheme proved inadequate, it led to a centralization of the general rules in the federal sphere, through a national complementary law. Albeit, annexation shall occur through state laws in accordance with the general provisions to be determined by such federal complementary law. Moreover, considering the analysis of federalism after the Constitutional Amendment 15/1996, states lost power to the union.It is noteworthy that annexation is still addressed in state law, but those laws must be subordinated to a general federal complementary law that does not exist – even after more than eighteen years of the edition of Constitutional Amendment 15.

Nevertheless, there are similarities between both Supreme Courts on the matter of inter-branch relations. The U.S.S.C. and the S.T.F. declared that it is necessary for the U.S. and Brazilian Congresses, respectively, to update or enact a particular legislative act.[155] The S.T.F. was considerably patient and deferent to Congress, waiting more than eleven years to declare the *inertia deliberandi* of Congress.[156] This fact also proves the strength of local politicians who benefitted personally from the absence of a national scheme in Brazil. The

contributed to fiscal crisis. KURT WEYLAND, *The Brazilian State in the New Democracy*, *in* DEMOCRATIC BRAZIL 42 (Peter R. Kingstone & Timothy J. Power eds., 2000).

[152] *See* KENT EATON, *Decentralization and Federalism*, *in* ROUTLEDGE HANDBOOK OF LATIN AMERICAN POLITICS 42 (Peter Kingstone & Deborah J. Yashar eds., 2012).

[153] *See* Hirschl, *supra* note 12, at 1348 (observed the Brazilian Constitution and its modern allocation of powers to local governments).

[154] CONSTITUIÇÃO FEDERAL [C.F.] art. 25 (Braz.).

[155] For a discussion of the U.S.S.C.: see Part II of this paper, when the *Shelby* Court emphasized that the U.S.S.C. determined that Congress did not act – or did not consider – despite previous warnings by the U.S.S.C. in a decision dating to 2009. The decision stated the necessity of an updated formula of section two. It took forty years for the U.S.S.C. to require an updated formula and four years to judge Congress delayed.

[156] For more information, see discussion in Part III of this paper.

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recently ousted President of Brazil vetoed a law that her own cabinet drafted. Hence, local political forces are very powerful in Brazil. In contrast, local governments are not, because they remain in an uncertain legal situation that denies the minimum standards for their own existence. In Brazil, local spheres are not embedded in the democratic experience traditionally associated with American localism, where local governments are perceived as the core of U.S. citizenship.[157]

Accordingly, the absence of provisions for local governments in the U.S Constitution can generally be considered as a successful experience. Findings of this study corroborate the idea that constitutional silence on issues that might be controversial at the time of the writing carries a positive impact in the future.[158] The proper relationship between state and cities was, in fact, a disputed political issue.[159] In this sense, the lack of provisions with regard to local matters was the preferred solution, to the extent that it would increase the chances of success in the future.[160] It would be naïve to argue that local governments should have been in the Constitution since its inception, because it would jeopardize the strength of federal union vis-à-vis states and local forces.

This study's findings are consistent with the understanding that constitutional amendments are not aimed at modifications of the

[157] Tocqueville remarked, in 1835, how local government was key for the principle of popular sovereignty in America. ALEXIS DE TOCQUEVILLE, DEMOCRACY IN AMERICA 69 (1835) ("In the town as elsewhere the people are the source of all social power, but nowhere do they exercise their power more directly."). More recently, disenchantment with this view emerged.

> City discretion of any kind evokes images of corruption, patronage, and even foolishness. This sense of necessity and desirability has made local powerlessness part of our definition of modern society, so that decentralization of power appears to be a nostalgic memory of an era gone forever or a dream of romantics who fail to understand the world as it really is.

See Frug, *supra* note 133, t 1067.

[158] For a discussion on incomplete theorization, see SUNSTEIN, *supra* note 93, at 58.

(Most of their virtues involve the constructive uses of silence. . . . Especially in a diverse society, silence – on something that may prove false, obtuse, or excessively contentious – can help minimize conflict, allow the present to learn from the future and save a great deal of time and expense. What is said and resolved is no more important than what is left out.)

[159] *See* Frug, *supra* note 133, at 1105–07 (pointing out the different conceptions of local government, namely the Jeffersonian view of local government as "elementary republic," as opposed to the skeptic Madisonian view). For the latter, see discussions by Madison on Federalists 10 and 51 regarding the advantages of the union over states to control factions, and how the federal system encapsulates a dual protection for the people. ALEXANDER HAMILTON, JOHN JAY, JAMES MADISON, THE FEDERALIST PAPERS 320-22 (Clinton Rossiter ed., 1999).

[160] *See* Walter F. Murphy, *Theories of Constitutional Design: Designing a Constitution: of Architects and Builders*, 87 TEX. L. REV. 1303-37 (2009).

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constitutional text, but at authorizing legislative and popular actors with an increased mechanism to pressure the interpretation of the highest court regarding that design.[161] Amendment procedures are tied to questions of judicial interpretation. The more difficult it is to amend a constitution, the higher the pressure on constitutional courts to decide issues addressing challenges posed by new conditions.[162]

The constitutional design adopted in Brazil authorized constitutional adaptation to the extent that the amendments aimed at eliminating the existence of several municipalities created or annexed for political interests only, without any concern for public needs. The amendments, however, increased litigation. The rate of annexation cases involving Brazilian municipalities jeopardizes economic growth, due to a lack of certainty regarding formation or modification. Accordingly, the design of the Brazilian Constitution cannot be deemed as successful, considering the litigation involving the annexation of local governments.

It has been argued that the impact of constitutional law in Latin America is different than in the United States due to the ease by which constitutional provisions can be ignored or changed.[163] The existence of two constitutional amendments about annexation and their current undefined legal situation, most unfortunately, prove that this remains the case. The decisions of the S.T.F. regarding annexations, however, indicate that there are grounds for optimism. The Court has been protecting the Constitution, striking a balance regarding the principle of separation of powers. As for the amendments, they ultimately contributed to the endurance of the democratic pact. The changes implemented by the amendments aimed at curbing the abuses that occurred when the constitutional requirement was merely one of state complementary law, instead of a national complementary law.

Finally, historical reasons and the related differences of their democratic experiences explain the two countries' distinct choices of constitutional design and the function served by each Supreme Court. It is clear

[161] *See* Rosalind Dixon, *Constitutional Amendment Rules: a Comparative Perspective*, *in* COMPARATIVE CONSTITUTIONAL LAW 96, 98-99 (Tom Ginsburg & Rosalind Dixon eds., 2011).
[162] *See* TUSHNET, *supra* note 8, at 1239.
[163] *See* Miguel Schor, *Constitutionalism Through the Looking Glass of Latin America*, 41 TEX. INT'L L.J. 1, 3-6 (2006).

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that Brazil can no longer contend that its own local governments are among the most empowered, if the rules for their own boundaries are not defined completely. In this direction, this analysis highlights potential reasons why there was not a full transplant of the U.S. federalism to the constitutional pact established in 1988. Local elites in Brazil were powerful enough to reject the general rule of the global constitutional market regarding the existence of two level spheres in federal systems (not three, as the Constitution of 1988 created).[164] Brazilians currently pay a high price for such innovation, despite the efforts of the S.T.F. in mitigating abuse.

5. CONCLUSION

This research investigates the decisions about annexation made by the U.S. Supreme Court and its Brazilian counterpart, the S.T.F., during the tenure of each current Constitution. This research discusses the impact of constitutional provisions concerning local governments on two different perspectives, as follows: protection of rights and constitutional design.

The decisions of both Supreme Courts demonstrate significant differences between their case law in subject matters of annexation. The U.S.S.C. initial decisions were about police powers and contractual claims, with significant deference to state powers. As the docket of the Court evolved over time, protection of fundamental rights, especially equality in light of the Voting Rights Act, became the bulk of litigation. Thus, the original unlimited conception of state power was reviewed in light of the national protection granted to fundamental rights. The discussed findings indicated that it is only recently that the U.S.S.C. became more involved in the litigation of federal rights in the context of annexation. After all, the Court has been acting in a careful and self-constrained fashion, being vigilant of its broad interpretation of the constitutional pact that grants states significant powers. Because local

[164] *See also*, Günter Frankenberg, *Constitutional Transfer: the IKEA Theory Revisited*, 8 INT'L. J. CONSTIT. L. 563, 570-76 (2010) (defining the concept of a global constitutional market and the importance of understanding the reasons why particular provisions are transferred differently to other jurisdictions in the field of Comparative Law).

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governments are still perceived as a qualified extension of states, they are remarkably powerful, albeit the absence of reserved constitutional provisions about them.

In sharp contrast with the U.S. scenario, all of the cases decided by the S.T.F. relate to formalities and constitutional procedures, with no single case protecting fundamental rights. In this way, the results of the comparison with the U.S.S.C. are counterintuitive, because one would expect the S.T.F. to be more involved in litigation regarding the protection of fundamental rights. This would be the case, if nothing else, due to the detailed provisions of the Brazilian Constitution, which generally confer many rights, increasing the chances of litigation.

In addition, local governments in Brazil did not turn to higher democratic spheres nationally, and they are not more inclusive of the less wealthy population. The current economical deficit of municipalities proves that, in Brazil, the exclusion of certain demographics of essential services may be accounted for by the lack of resources that this same population should be granted access. The decisions of the S.T.F. aimed to balance the system established by the Constitution of 1988. Nevertheless, the Court has its own limitations with regard to other branches of power and influential local forces. Despite the decisions of the S.T.F., local governments are, de facto, annexing each other without the existence of the federal complementary law. This is a clear violation of the rule of law, and it generates great uncertainty as for the legal regime applicable to those municipalities that are changing their boundaries. It also produces unnecessary litigation, which is a considerable burden on the allocation of resources and budget matters.

This research uses annexation as a proxy for local powers, and it does not argue that one constitutional design is necessarily superior to the other. The silence of the U.S. Constitution and the recent inclusion of municipalities as federal actors in Brazil are considered as choices to reach the best feasible option at the time of constitutional writing. In that view, as any controversial constitutional choice, it was a product of compromise. Therefore, this research maintains that the absence of provisions about local governments in the U.S. Constitution can be generally viewed as successful, in light of the current

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constitutional design literature about the lack of provisions relating to controversial matters at the time of the convention.

After two constitutional amendments and recent decisions of the S.T.F. rendering unconstitutional the current inaction of Congress in approving the required federal complementary law, no evidence was found to support the proposition that the inclusion of municipalities as federal actors is necessarily superior to the current comparative trend that uses the dual spheres system of the U.S. federalism as a paradigm. The findings do not validate propositions considering the constitutional design after 1988 as a failure, either. This is so because the S.T.F. tried to minimize abuses referring to annexation in different cases. Further, the current Constitution has less than thirty years of existence. This timeframe is considerably short when compared with the more than 200 years of the U.S. Constitution. Therefore, our findings do not support that the U.S. system, i.e., the absence of provisions of local governments, should be transplanted to the Brazilian Constitution.

In conclusion, as it is often the case with legal transplants, there are different foundations upon which the texts rest. The people of the United States are largely concerned with their local governments, with this sphere of power traditionally viewed as a manifestation of their democracy. Brazil is different. On the one hand, Brazil has been an exploit colony of Portugal, survived dictators and decades of military rulings, which are examples of a centralization of powers in the federal sphere. On the other hand, the democratic Constitution of 1988 innovated in the sense of having local governments explicitly named as federal actors, adding complexity to the balance of federal powers. Constitutional design is a process in which " non-ideational obstacles are strong, ... the interests affected are non uniform, and retrogression is possible after adoption."[165] The comparison about the reasoning of U.S. Supreme Court and Brazilian Supreme Court provides reasons to be optimistic about the future, to the extent that both Supreme Courts have been fierce guardians of the rule of law and related constitutional values.

[165] HOROWITZ, *supra* note 95, at 16.

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Table 1: Final List of Annexation Cases by the U.S.S.C.

Final List of Cases	Year	Issue
Virginia v. West Virginia, 78 U.S. 39	1870	Annexation of counties in Virginia
Slaughter-House Cases, 83 U.S. 36	1872	Police powers of the state
Comm'rs of Laramie v. Comm'rs of Albany, 92 U.S. 307	1875	County reduction and debt payment
Mt. Pleasant v. Beckwith, 100 U.S. 514	1879	Bonds and extinction municipality
Mobile v. Watson, 116 U.S. 289	1886	City's legal successor
Forsyth v. Hammond, 166 U.S. 06	1897	Tax and county comm. Board ann.
Holden v. Hardy, 169 U.S. 366	1898	Utah police powers
McCain v. Des Moines, 174 U.S. 168	1899	Annexation under color of law
Clark v. Kansas City, 176 U.S. 114	1900	Individuals and corp. annexation land
Worcester v. Worcester Consol. St. Ry. Co., 196 U.S. 539	1905	State interfering with municipality
Blair v. City of Chicago, 201 U.S. 400	1906	Right of the city to grant license
Hunter v. Pittsburgh, 207 U.S. 161	1907	Consolidation of two cities and taxes
Detroit United Ry. v. Detroit, 229 U.S. 39	1913	Contractual rights
Detroit United Ry. v. Michigan, 242 U.S. 238	1916	City fares and Contract Clause
Howard v. Comm'rs of Sinking Fund, 344 U.S. 624	1953	Annexation of federal area by munic.
Gomillion v. Lightfoot, 364 U.S. 339	1960	State limited powers: disenfranchise
Perkins v. Matthews, 400 U.S. 379	1971	Voting Rights Act
Mahan v. Howell, 410 U.S. 315	1973	Virginia's reapportionment statute
Richmond v. United States, 422 U.S. 358	1975	Voting Rights Act
United Jewish Orgs., Inc. v. Carey, 430 U.S. 144	1977	Voting Rights Act
Town of Lockport v. Citizens for Cmty. Action at the Local Level, Inc., 430 U.S. 259	1977	Equal Protection of Fourteenth Am.
Holt Civic Club v. Tuscaloosa, 439 U.S. 60	1978	State police powers
City of Rome v. United States, 446 U.S. 156	1980	Voting Rights Act
Port Arthur v. United States, 459 U.S. 159	1982	Voting Rights Act
Pleasant Grove v. United States, 479 U.S. 462	1987	Voting Rights Act
Presley v. Etowah Cty. Comm'n, 502 U.S. 491	1992	Voting Rights Act
Shaw v. Reno, 509 U.S. 630	1993	Voting Rights Act
Holder v. Hall, 512 U.S. 874	1994	Voting Rights Act
Johnson v. De Grandy, 512 U.S. 997	1994	Voting Rights Act

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FTC v. Phoebe Putney Health Sys., 133 S. Ct. 1003	2013	State legislative power and the city
Shelby Cty. v. Holder, 133 S. Ct. 2612	2013	Voting Rights Act as unconstitutional

Table 2: Final decisions of the S.T.F.

Final list of cases of S.T.F. decisions	Year	Issue
ADI 1372 MC/ RJ	1995	Plebiscite
ADI 1373 MC/ PR	1995	Plebiscite
ADI 2381 MC/ RS	2001	Suspension/perennial clause
ADI 2632 MC/BA	2002	Condition fed. complementary law
ADI 2702/PA	2003	Condition fed. complementary law
ADI 2632/BA	2004	Condition fed. complementary law
ADI 2994/BA	2004	Condition fed. complementary law
ADI 3149/SC	2004	Condition fed. complementary law
ADI 3615/ PB	2006	Condition fed. complementary law
ADI 2240/BA	2007	Change of S.T.F.'s case law
ADI 3489/SC	2007	Change S.T.F.'s case law
ADI 3316/MT	2007	Change S.T.F.'s case law
ADI 3682/MT	2007	Change S.T.F.'s case law
ADI 3689/PA	2007	Reiterate change in S.T.F.'s case law
ADI 2395/DF	2007	Denial of federalism perennial clause
ADI 4992MC/RO	2013	Denial of annexation based on CA 57

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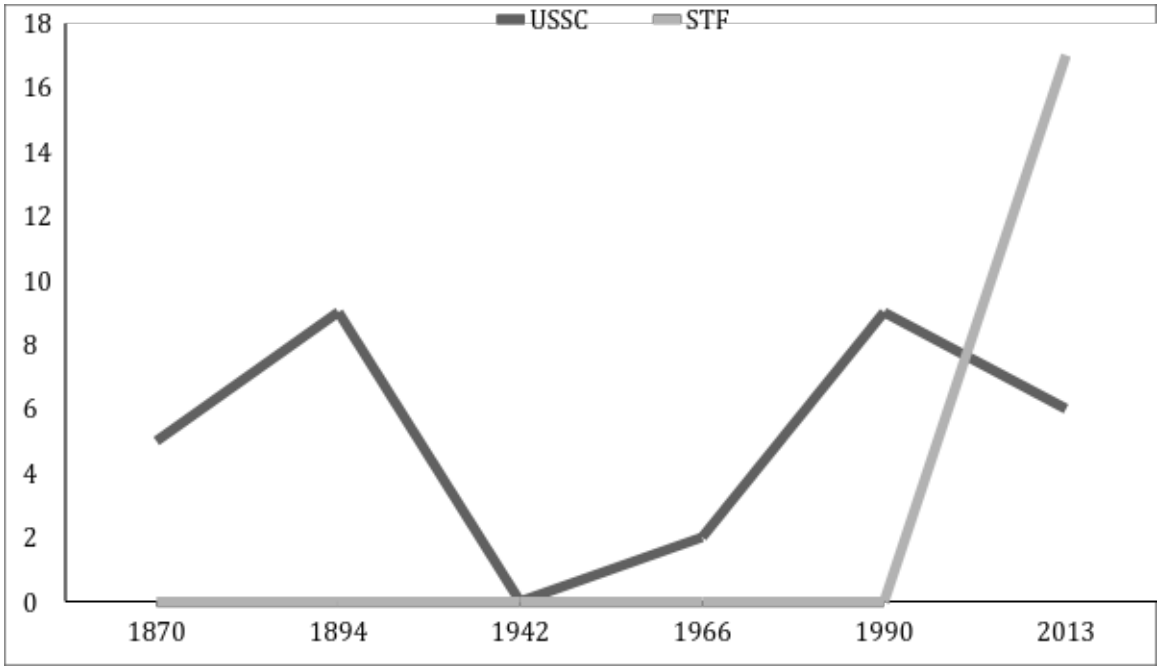
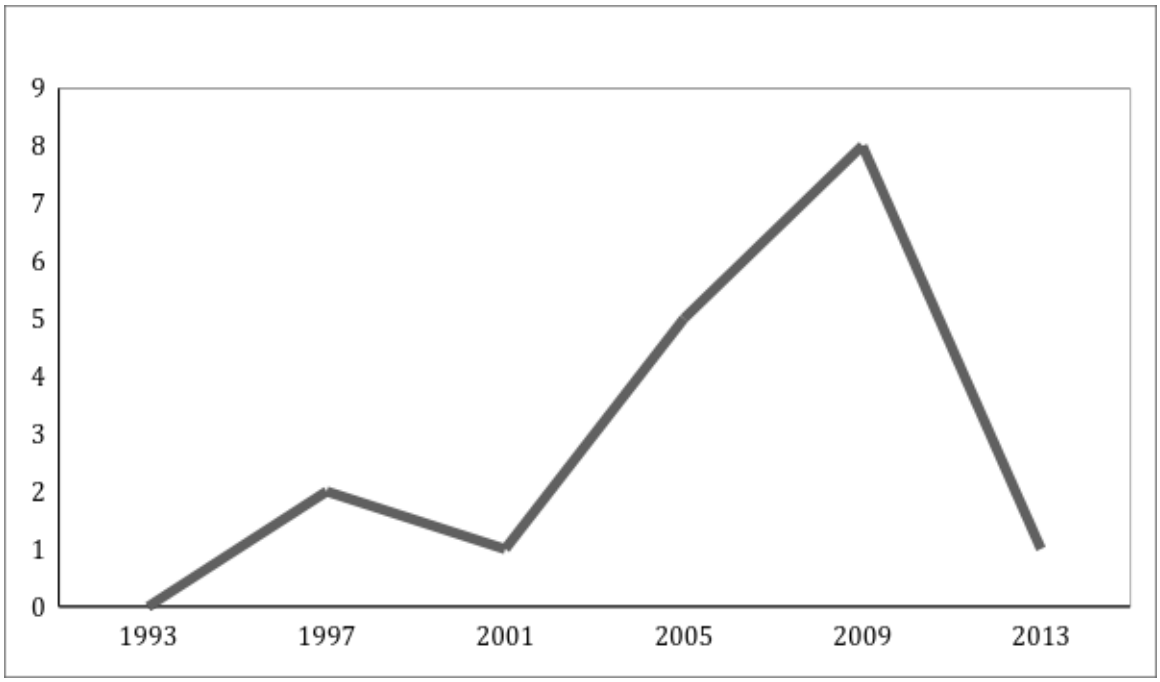


Picture no. 1: Comparison of the decisions of the U.S.S.C. and the S.T.F.: Number of lawsuits from 1870 until February, 2014 involving annexation of local governments



Picture no. 2: Decisions of the S.T.F.: Number of lawsuits from 1988 until February, 2014

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Britain in Palestine (1917-1948) - Occupation, the Palestine Mandate, and International Law

PATRICK C. R. TERRY[†]

TABLE OF CONTENTS: 1. Introduction; 2. The Balfour Declaration; 2.1. The Letter; 2.2. Background; 2.3. Controversies Surrounding the Balfour Declaration; 2.3.1. The "Too Much Promised" Land; 2.3.1.1. Sykes-Picot-Agreement (1916); 2.3.1.2. Mcmahon-Hussein Correspondence (1915/1916); 2.3.2. International Legal Status of the Balfour Declaration; 2.3.3. Interpretation of The Text; 3. British Occupation of Palestine (1917-1923); 4. The Palestine Mandate; 4.1. The Mandates System; 4.1.1. Self-Determination and President Wilson; 4.1.2. Covenant of The League of Nations; 4.1.2.1. Article 22; 4.1.2.2. Sovereignty; 4.1.2.3. Assessment; 4.1.3. President Wilson's Concept of Self-Determination and The Covenant; 4.2. The Palestine Mandate in Detail; 4.2.1. First Decisions; 4.2.2. Turkey; 4.2.3. The Mandate's Provisions; 4.2.4. The Mandate's Legality; 4.2.4.1. Self-Determination; 4.2.4.2. Article 22 (4) Covenant of The League of Nations; 4.2.4.3. Other Violations of International Law; 5. Conclusion.

ABSTRACT: At a time when there are not even negotiations between Israel and the Palestinians in order to resolve their longstanding dispute, this article seeks to explain the origins of the conflict by examining Britain's conduct in Palestine from 1917-1948, first as an occupier, then as the responsible mandatory, under international law. Although at first sight dealing with a purely historical issue, a discussion of British conduct in Palestine is relevant at a time when the realization of a viable two-State-solution to the conflict between Israel and the Palestinians is becoming ever more urgent and concurrently less likely. This article analyses the developments in Palestine as of 1917 and the legality, in international law, of (mainly) British actions. It will be argued that British attempts at implementing the Balfour Declaration -which, as will be shown, had no standing in international law- while being occupiers of enemy territory were contrary to the Hague Regulations as acknowledged by leading British officials at the time. It will then be explained that the Palestine Mandate, as confirmed by the League of Nations' Council, contravened Article 22 (4) of the League of Nations Covenant, and that British efforts to implement it as of 1920 -and thus four years before the peace treaty with Turkey came into force- were similarly inconsistent with the Hague Regulations. Far from believing in the legality of their actions, leading British officials and politicians were, as will be documented, well aware of their conduct's "legal imperfections". It will be concluded that British conduct in Palestine could rarely, if at all, claim to be accordance with the new international legal order the UK had helped to create following WWI. Repeatedly ignoring international law did not benefit the British: their rule in Palestine was to end in humiliating defeat in 1948. Almost seventy years later the world is still trying to resolve a conflict the British set in motion in 1917 with the issuance of the Balfour Declaration.

KEYWORDS: *Palestine (1917-1948); United Kingdom; Public International Law*

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The contradiction between the letters of the Covenant and the policies of the Allies is even more flagrant in the case of 'independent' Palestine. . .
What I have never been able to understand is how it can be harmonized with the declaration, the Covenant, or the instructions to the Commission of Enquiry. . .[1]

1. INTRODUCTION

The conflict in Palestine is one of the most enduring in the world. To many, it remains a mystery why the parties cannot reach a just and sensible agreement based on international law. Some claim this is due to the conflict parties' "legal fundamentalism" and accuse mainly the Palestinian Arabs of constantly reverting to legal arguments, thereby making compromise impossible.[2] This article, however, will show that the Palestinian Arab position is more understandable when Palestine's history under British rule is considered.

Although it is true that a just solution for the future cannot be found by dwelling on the past, it seems obvious that if wrongs committed are not at least acknowledged during negotiations the party subjected to them -in this case, the Palestinian Arabs- will continue to perceive any solution as unjust. Furthermore, ignoring past illegal actions does nothing more than highlight the weakness of the contrary legal arguments, and can only increase distrust on the part of those to whose disadvantage such a course of action is.

Beginning with the Balfour Declaration in 1917, and ending with the recognition of the State of Israel in 1948, virtually all the steps undertaken by Britain were contrary to the international legal order it had helped create. Palestinian Arabs suffered the consequences of British actions, which culminated in the creation of a new state. The statements accompanying these actions, however, stressed their legality or, more commonly, ignored legal issues.

The story of Palestine and international law begins in the First World War. Palestine, still under Ottoman rule at that time, became the "too much

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[1] British Foreign Secretary Arthur Balfour in a Memorandum (dated 11st August 1919) to Earl Curzon; extracts reprinted in Doreen Ingrams, *Palestine Papers 1917-1922, Seeds of Conflict*, London: John Murray Publishers Ltd. (1972), 73 (PRO. FO. 371/4183).

[2] *See* JOHN STRAWSON, PARTITIONING PALESTINE, LEGAL FUNDAMENTALISM IN THE PALESTINIAN-ISRAELI CONFLICT (2010).

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promised land".[3] Britain and France had agreed it would be under an international regime in the event of victory, while the British might have promised the Arabs that Palestine or parts of Palestine would be included in an independent Arab state. Moreover, the British government "viewed with favour" the establishment of a "Jewish national home" there.

Britain, having become reliant on the Suez Canal as a vital transport link, mainly wanted to create a reliable European outpost near the Canal by establishing such a "homeland" and hoped that by gaining Jewish favour the outcome of the First World War could be influenced in a positive way. The United Kingdom did not achieve these objectives. Far from creating a stable outpost near the Suez Canal, Britain, burdened by having made too many contradictory promises, would scramble to remain in control of Palestine. After thirty years of futile attempts at restoring order, Britain, in 1947, at last acknowledged its defeat.

This sorry story began in 1917. Following Palestine's occupation Britain went on to assure itself of the Palestine Mandate, based on the newly developed mandates system. Irreconcilable promises and safeguards in the Mandate soon meant that Britain was having ever more difficulties in adhering to its provisions. The attempt at remaining within the terms laid down after the First World War finally was abandoned in the late 1930s, when it proved too arduous for Britain to keep unrest at bay.

This article will demonstrate that none of the major British actions in Palestine was consistent with international law. After briefly explaining and interpreting the Balfour Declaration of 1917, and showing that it had no standing in international law, the British regime of occupation in Palestine will be examined. First attempts at implementing the Balfour Declaration as of 1920 will be shown to have been contrary to the 1907 Hague Regulations to which Britain was a party.

Following an analysis of the mandates system conceived by the victorious First World War Allies, which will illustrate why that system fell short of U.S. President Wilson's much heralded principle of self-determination,

[3] A. E. Prince, *The Palestine Impasse*, 1 INT'L J. 122, 125 (1946); Robert Gale Woolbert, *Pan Arabism and the Palestine Problem*, 16 FOREIGN AFF. 309, 311 (1938).

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the Palestine Mandate will be examined in some detail. It will be argued that the terms of that mandate could not be reconciled with Article 22 (4) of the Covenant of the League of Nations (hereinafter the Covenant).

By 1947, the British had realized they would not be able to fulfil their obligations. Various earlier U-turns based on contradictory commission reports had foreshadowed this result. In the end, violating international law had become the norm. Nevertheless, this course of action had not benefitted Britain, instead culminating in a humiliating defeat.

It should be noted that this article will not deal extensively with historic Arab and Jewish claims and counter-claims on Palestine, which frequently go back thousands of years,[4] as these can -at best- be described as providing a "dubious prescriptive right" in international law,[5] or, more accurately, as not providing any legal entitlement at all.[6] Furthermore, this article does not deal

[4] For a more detailed look at these claims, see: Carsten Wieland, *"Thousands of Years of Nation-Building? Ancient Arguments for Sovereignty in Bosnia and Israel/Palestine" in* NATION BUILDING BETWEEN NATIONAL SOVEREIGNTY AND INTERNATIONAL INTERVENTION, BADEN-BADEN: NOMOS VERLAGSGESELLSCHAFT 81, 86-97 (Henriette Riegler ed., 2005); *see also* John A. Collins, *Self-Determination in International Law: The Palestinians*, 12 CASE W. RES. J. INT'L 137, 155 (1980); (he briefly describes Jewish claims going back to 1800 B.C. (Abraham) and Arab claims relating to the Canaanites, dating back to about 3000 B.C.); Prince, *supra* note 3, at 122-123; ELI MURLAKOV, DAS RECHT DER VÖLKER AUF SELBSTBESTIMMUNG IM ISRAELISCH-ARABISCHEN KONFLIKT 35-38 (1983).

[5] Felix Frankfurter, *The Palestine Situation Restated*, 9 FOREIGN AFF. 409, 411 (1931) (it should be noted that Frankfurter was President of the American Zionist Organization).

[6] The King-Crane Commission, sent to the Middle East by the United States in 1919 in order to determine what local feeling was, pointed out: "For the initial claim, often submitted by Zionist representatives, that they have a "right" to Palestine, based on an occupation of two thousand years ago, can hardly be seriously considered."; *see* Recommendations of the King-Crane-Commission, para. 5 (Aug. 28, 1919), http://www.jewishvirtuallibrary.org/jsource/History/crane.html; similarly, the I.C.J. in a case concerning title to islands off the coast of Jersey, declared, referring to a judgment from 1202 France was relying on: "To revive its legal force to-day by attributing legal effects to it after an interval of more than seven centuries seems to lead far beyond any reasonable application of legal principles"; later on in the judgement the court added: "What is of decisive importance, in the opinion of the Court, is not indirect presumptions deduced from events in the Middle Ages, but the evidence which relates directly to the possession of the Ecrehos and Minquiers groups"; *see also* The Minquiers and Ecrehos Case (France v. United Kingdom), Judgment, 1953 I.C.J. Rep. 47, 57 (November 17); Lord Curzon (at the time British Foreign Secretary), responding to a draft of the Palestine Mandate, in a minute of 6th August1920: "I do not myself recognise that the connection of the Jews with Palestine, which terminated 1200 years ago, gives them any claim whatsoever. On this principle we have a stronger claim to parts of France."; reprinted in Ingrams, *supra* note 1, at 98 (PRO. FO. 371/5245); VICTOR KATTAN, FROM COEXISTENCE TO CONQUEST: INTERNATIONAL LAW AND THE ORIGINS OF THE ARAB-ISRAELI CONFLICT 1891-1949, at 50-52 (2009); J.B. McGeachy, *Is it Peace in Palestine?*, 3 INT'L J. 239, 241 (1948); Collins, *supra* note 4, at 156; JEREMY SALT, THE UNMAKING OF THE MIDDLE EAST: A HISTORY OF WESTERN DISORDER IN ARAB LANDS 124 (2009); Phillip J. Gendell & Paul G. Stark, *Israel: Conqueror, Liberator, or Occupier Within the Context of International Law*, 7 SW. U.L. REV. 206, 216 (1975); they seem to disagree. Without offering any explanation, they assume that there was a legal right of self-determination prior to the Second World War; they claim that this "most important concept" was "the right of the Jewish People to self-determination within the confines of the historical land of Israel"; Murlakov, *supra* note 4, at 50; he argues that the historical

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with the legality of the creation of the State of Israel against the backdrop of the situation in Palestine in mid-1948.[7]

2. THE BALFOUR DECLARATION

2.1. THE LETTER

The so-called Balfour Declaration is actually a letter by the British Foreign Secretary addressed to a prominent supporter and benefactor of the Zionist movement, Lord Rothschild, dated November 2nd, 1917.

Its contents are as follows:

> Dear Lord Rothschild,
>
> I have much pleasure in conveying to you, on behalf of His Majesty's Government, the following declaration of sympathy with Jewish Zionist aspirations which has been submitted to, and approved by, the Cabinet:
>
> His Majesty's Government view with favour the establishment in Palestine of a national home for the Jewish people, and will use their best endeavours to facilitate the achievement of this object, it being clearly understood that nothing shall be done which may prejudice the civil and religious rights of existing non-Jewish communities in

connection of the Jews to Palestine justifies the realization of their right of self-determination there. This frequently repeated argument is to b+e rejected. Authors who put forward this argument invariably justify the treatment of the Palestinian Arabs on the grounds that there was no legal right of self-determination at that time (a notion supported here). It then, however, seems contradictory to base Jewish claims to Palestine on such a right. Furthermore, accepting the "historical connection" argument in international law would self-evidently lead to chaos, as many borders worldwide would have to be redrawn. It also seems obvious that religious notions should not determine international law, as there are five "world religions", apart from many others, that would have to be respected. Furthermore, the fact the Zionist movement even contemplated alternatives, such as Argentina or Uganda, undermines the argument. These arguments also militate against accepting Sol M. Linowitz's argument in Sol Myron Linowitz, *Analysis of a Tinderbox: The Legal Basis for the State of Israel,* 43 AM. B. ASS'N J. 522, 524 (1957) who -based on ancient history- argues that the Jews were "deprived" of their "sovereignty by force" and had "never renounced it".

[7] *See* JOHN DUGARD, RECOGNITION AND THE UNITED NATIONS 62 (1987); he makes a similar point when he states: "The meaning of the Balfour Declaration, the validity of the Partition Plan approved in Resolution 181 (II), and the moral basis of the State of Israel are still a cause for debate. However, this debate does not affect Israel's position as a State in the international community…"; *see also* JOHN QUIGLEY, THE STATEHOOD OF PALESTINE: INTERNATIONAL LAW IN THE MIDDLE EAST CONFLICT 120-21 (2010).

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> Palestine, or the rights and political status enjoyed by Jews in any other country.
>
> I would be grateful if you would bring this declaration to the knowledge of the Zionist Federation.
>
> Yours, Arthur James Balfour[8]

2.2. BACKGROUND

Many developments during the First World War came together to facilitate the adoption of this pro-Zionist statement by the British government. Its approval of Zionist aspirations was mainly due to two rather different considerations: the religious beliefs of many of the decisive politicians,[9] and, more importantly, strategic concerns in the context of the First World War and its aftermath.[10]

Many of the most influential supporters of Zionism were ardent Protestants.[11] Balfour and the Prime Minister, Lloyd George, were "brought up on the Bible" and -similar to Christian fundamentalists in the United States nowadays- believed the return of the Jews to Palestine was inevitable.[12] These strongly held beliefs led them to be natural supporters of Zionist aspirations.[13]

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[8] "The Balfour Declaration", <http://news.bbc.co.uk/1/hi/in_depth/middle_east/israel_and_the_palestinians/key_documents/1682961.stm>.

[9] Frankfurter, *supra* note 5, at 413 (he mentions "the sway that the Old Testament and thereby Palestine exercised over British imagination" as one of the motives for British policies in Palestine); *see also* ANTHONY PARSONS, FROM COLD WAR TO HOT PEACE: UN INTERVENTIONS 1947-1995, at 3 (1995); Salt, *supra* note 6, at 123; DAVID FROMKIN, A PEACE TO END ALL PEACE: THE FALL OF THE OTTOMAN EMPIRE AND THE CREATION OF THE MODERN MIDDLE EAST 267-68, 274, 283, 298 (2000); Ingrams, *supra* note 1, at 5; Kattan, *supra* note 6, at 70; Strawson, *supra* note 2, at 28; Avi Shlaim, *Israel and Palestine*, London: Verso (2009), 11; JOHN KEAY, SOWING THE WIND: THE MISMANAGEMENT OF THE MIDDLE EAST 1900-1960, at 79, 82 (2004).

[10] *See* Herbert Louis Samuel, *Alternatives to Partition*, 16 FOREIGN AFF. 143 (1937); Chaim Weizmann, *Palestine's Role in the Solution of the Jewish Problem*, 20 FOREIGN AFF. 324, 336 (1941); ALAIN GRESH, DE QUOI LA PALESTINE EST-ELLE LE NOM?" 63 (2010).

[11] *See* Ilan Pappe, *Clusters of history: US involvement in the Palestine Question*, 48 RACE & CLASS 1, 3-8 (2007); (he describes the pro-Zionist influence of leading Protestants in America as early as the late nineteenth century, based on ideas derived from Scottish and Irish Protestants).

[12] *See* KENNETH YOUNG, ARTHUR JAMES BALFOUR 387-88 (1963); Fromkin, *supra* note 9, at 267-268, 274, 283, 298; Ingrams, *supra* note 1, at 5; Gresh, *supra* note 10, at 66-67 (he refers to the South African Smuts' religious beliefs; General Smuts was a member of the Imperial War Cabinet and instrumental in developing the whole concept of the mandates system); MARGARET MACMILLAN, PEACEMAKERS: SIX MONTHS THAT CHANGED THE WORLD 425-26 (2002).

[13] Young, *supra* note 12, at 387-388; Fromkin, *supra* note 9, at 267-268, 274, 283, 298.

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Nevertheless, for most of the project's supporters, political reasons were decisive. Some had the suspicion that Jews had enormous influence within the Ottoman Empire, especially among the Young Turk movement.[14] Many also thought that Jewish Russians might be decisive in keeping Russia in the war in support of the allies before and after the Tsar had been overthrown:[15]

> It is clear that at that stage His Majesty's Government were mainly concerned with the question of how Russia . . . . was to be kept in the ranks of the Allies . . . . The idea was that such a declaration [of sympathy for Jewish national aspirations] might counteract Jewish pacifist propaganda in Russia.[16]

Moreover, some believed that Jewish Americans might persuade the US Government to enter the war, and that this subsequently might persuade some of the wealthy among them to support the Allied cause financially:[17] "It was supposed that American opinion might be favourably influenced if His Majesty's Government gave an assurance that the return of the Jews to Palestine had become a purpose of British policy."[18]

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[14] Fromkin, *supra* note 9, at 92; Kattan, *supra* note 6, at 70-71; *see also* JONATHAN SCHNEER, THE BALFOUR DECLARATION: THE ORIGINS OF THE ARAB-ISRAELI CONFLICT 153-154 (2010).

[15] Fromkin, *supra* note 9, at 286-288, 296; Quigley, *supra* note 7, at 13; Kattan, *supra* note 6, at 70-71, 75-76; Schneer, *supra* note 14, at 153-154, 214; Shlaim, *supra* note 9, at 9; see also FRANK OWEN, TEMPESTUOUS JOURNEY: LLOYD GEORGE, HIS LIFE AND TIMES 427 (1954); Macmillan, *supra* note 12, at 427.

[16] William Ormsby-Gore, Parliamentary Under Secretary of State for the Colonies, in a 1922 Memorandum (on the origins of the Balfour Declaration) for Winston Churchill, then Secretary of State for the Colonies; extracts reprinted in Ingrams, *supra* note 1, at 7-8 (PRO. CAB. 24/158). In a Memorandum by Ronald Graham, Assistant Under Secretary of State for Foreign Affairs, to Lord Hardinge, this view is expressed as follows: "We ought therefore to secure all the political advantage we can out of our connection with Zionism and there is no doubt that this advantage will be considerable, especially in Russia . . . . "; reprinted in Ingrams, *supra* note 1, at 8 (PRO. FO. 371/3058). Fears remained even after the war: during a meeting of the Eastern Committee on December 5th, 1918, the Director of Military Intelligence, General Macdonogh, declared that he had heard that "if the Jewish people did not get what they wanted in Palestine we should have the whole of Jewry turning Bolsheviks and supporting Bolshevism in all the other countries as they have done in Russia . . . ."; reprinted in Ingrams, *supra* note 1, at 50 (PRO. CAB. 27/24).

[17] *See* William Ormsby-Gore, Parliamentary Under Secretary of State for the Colonies, in a 1922 Memorandum (on the origins of the Balfour Declaration) to Winston Churchill, then Secretary of State for the Colonies, *supra* note 16; Fromkin, *supra* note 9, at 286-288, 296; Quigley, *supra* note 7, at 14; *see also* Günther Weiß, *Die Entstehung des Staates Israel Teil 1*, 13 ZAöRV 146, 146-172 (1950); JEAN ALLAIN, INTERNATIONAL LAW IN THE MIDDLE EAST: CLOSER TO POWER THAN JUSTICE 76 (2004); Parsons, *supra* note 9, at 3; Kattan, *supra* note 6, at 70-71, 75-76; Schneer, *supra* note 14, at 154-155; Shlaim, *supra* note 9, at 9; Owen, *supra* note 15, at 426, 427; Macmillan, *supra* note 12, at 427.

[18] William Ormsby-Gore, Parliamentary Under Secretary of State for the Colonies, in a 1922 Memorandum (on the origins of the Balfour Declaration) for Winston Churchill, then Secretary of State for the Colonies; *supra* note 16. In a meeting of the War Cabinet on 3rd September 1917, during a debate on whether to proceed with the Declaration, the Acting Foreign Secretary, Lord Cecil, declared that "there was a very strong and enthusiastic organization, more particularly in the United States, who were zealous in this matter, and his belief was that it would be of most

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During a debate in the House of Commons, Winston Churchill partly confirmed this analysis of British motives:

> They [the pledges] were made because it was considered they would be of value to us in our struggle to win the War. It was considered that the support which the Jews could give us all over the world, and particularly in the United States, and also in Russia, would be a definite palpable advantage.[19]

These assumptions were based on unfounded illusions and rumours;[20] however, they were decisive in persuading a majority of the British cabinet to support the issuance of the Balfour Declaration.

Other strategic concerns seem more rational. Realizing the Suez Canal's potential for trade, and recognizing Palestine as a vital link in the route between the British possessions in Africa and India via the British-dominated Egypt, some politicians believed that it might be useful to have a "European people" -and the prospective Jewish settlers were, of course, mostly European- settle in Palestine post-victory. Generally, Arabs were seen as less trustworthy.[21] Ronald Storrs, Military Governor in Palestine as of 1917, described this policy as creating "a little loyal Ulster in the heart of a fundamentally hostile Arabia."[22] Furthermore, Palestine was viewed as an ideal buffer between any other foreign presence in the Middle East and Egypt with its canal:[23]

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substantial assistance to the Allies to have the earnestness and the enthusiasm of these people enlisted on our side."; extracts reprinted in Ingrams, *supra* note 1, at 10 (PRO. FO. 23/4); also quoted in Quigley, *supra* note 7, at 14.

[19] Winston Churchill, Secretary of State for the Colonies, during a debate in the House of Commons on 4th July 1922; Hansard, Commons Sitting, ser 5 vol 156, Colonial Office, cc221-343, c329; (July 4, 1922).

[20] Shlaim, *supra* note 9, at 10-11; Kattan, *supra* note 6, at 75; Schneer, *supra* note 14, at 152-153, 343, 366.

[21] Allain, *supra* note 17, at 77; Parsons, *supra* note 9, at 3; Quincy Wright, *Legal Aspects of the Middle East Situation*, 33 L. & CONTEMP. PROBS. 5, 12 (1968); Salt, *supra* note 6, at 123; KONRAD W. WATRIN, MACHTWECHSEL IM NAHMEN OSTEN: GROSSBRITANNIENS NIEDERGANG UND DER AUFSTIEG DER VEREINIGTEN STAATEN 1941-1947, at 58-59, 66 (1989); Fromkin, *supra* note 9, at 281, 295; Kattan, *supra* note 6, at 64, 70-71; Gresh, *supra* note 10, at 48-49, 57, 62-63; JAMES BARR, A LINE IN THE SAND: BRITAIN, FRANCE AND THE STRUGGLE THAT SHAPED THE MIDDLE EAST 56 (2011); *see, e.g.*, ANTONY ANGHIE, IMPERIALISM, SOVEREIGNTY AND THE MAKING OF INTERNATIONAL LAW 141-44 (2005) (more generally on the European economic interests behind the establishment of the mandates system).

[22] Ronald Storrs, quoted in Keay, *supra* note 9, at 195; Weizmann is alleged to have described a future Jewish Palestine as an "Asiatic Belgium" (Macmillan, *supra* note 12, at 427).

[23] Shlaim, *supra* note 9, at 9; Ingrams, *supra* note 1, at 36; Kattan, *supra* note 6, at 30, 38-39; Keay, *supra* note 9, at 81, 195, 244; Gresh, *supra* note 10, at 57, 62-63; Gresh views the Declaration partly as a British attempt to extricate itself from its obligations towards France arising from the Sykes-

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> Palestine adjoins the Sinai Peninsula, the Suez Canal, and Akaba, and a British railway from Akka-Haifa to Iraq would traverse Palestine in its first section. It is therefore a British desideratum that if the effective government of Palestine demands the intervention of a single outside power in its administration, that Power should be either Great Britain or the United States . . . .[24]

The consequences for the Muslim and Christian Arabs -who formed the vast majority of the population-[25] of creating a Jewish national home in Palestine, did not figure prominently among British politicians' concerns.[26] As the Prime Minister, Lloyd George, later put it: "We could not get in touch with the Palestinian Arabs as they were fighting against us."[27]

Their "religious and civil rights" were protected in the Declaration, but not much more thought was given to local reaction. Since at the time Arab states did not exist in the area ruled by the Ottomans, some politicians might have convinced themselves that the putative independent Arab state(s) would be getting so much territory that the Arabs ultimately would be indifferent to the establishment of a Jewish home in Palestine.[28]

Picot-Agreement of 1916; a point also made by Wright, *supra* note 21, at 12; Barr, *supra* note 21, at 56; Macmillan, *supra* note 12, at 427.

[24] Arnold Toynbee (Political Intelligence Department at the Foreign Office) in a memorandum of October 1918; extracts reprinted in Ingrams, *supra* note 1, at 40-41 (PRO. FO. 371/4368); similar sentiments were expressed by the Minister without Portfolio, Chamberlain, during a meeting of the War Cabinet on 15th August 1918: "With regard to Mesopotamia, Palestine and East Africa, the question resolved itself into one of the security of the British Empire and of its allies."; reprinted in Ingrams, *ibid*, 38-40 (PRO. FO. 800/221). During a meeting on 10th September 1919, General Shea pointed out that "from the point of the air he thought it essential to have Palestine. The necessity of this was to break up an air attack on the Suez Canal."; Minutes reprinted in Ingrams, *ibid*, 75-78 (PRO. CAB. 21/153).

[25] On 6th December 1918, Sir Gilbert Clayton, Chief Political Officer Egyptian Expeditionary Forces, estimated the population in Palestine to be as follows: "Moslems 512,000; Christians 61,000; Jews 66,000"; reprinted in Ingrams, *supra* note 1, at 43-44; Mahmoud Cherif Bassiouni, *Self-Determination and the Palestinians*, 65 AM. SOC'Y INT'L L. 31, 35 (1971) (90%); Ilan Dunsky, *Israel, the Arabs, and International Law: Whose Palestine Is It, Anyway?*, 2 DALHOUSIE J. LEGAL STUD. 163, 168 (1993) (85%); Prince, *supra* note 3, at 125 (90%).

[26] In a record of a meeting between the British Foreign Secretary Balfour and the leader of the British Zionists, Chaim Weizman, on 4th December 1918, it is stated that "Mr Balfour agreed that the Arab problem need not be regarded as a serious hindrance in the way of the development of a Jewish National Home."; reprinted in Ingrams, *supra* note 1, at 46 (PRO. FO. 371/3385); Fromkin, *supra* note 9, at 297.

[27] Lloyd George; quoted in Fromkin, supra note 9, at 297; the Military Governor in Palestine as of 1917, Ronald Storrs, later remarked: "The Declaration . . . took no account of the feelings or desires of the actual inhabitants of Palestine." [in:Sir Ronald Storrs, Orientations 352 (1943)].

[28] *See* SAMI HADAWI, PALESTINIAN RIGHTS AND LOSSES IN 1948, at 6-9 (1988); he demonstrates how ridiculous such an assumption was, when he details resistance to Zionist landowners developing as early as the late nineteenth century. Nevertheless, even after the Second World War, this argument was still being put forward: Abba Solomon Eban, *Israel: The Emergence of a Democracy*, 29

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Some, among them many Zionists, also believed that the local "backward" population could only benefit from the colonisation by a "civilized", mainly European people.[29] It was argued repeatedly that the Arabs of Palestine would probably become the wealthiest Arabs in the area, thanks to future Zionist efforts.[30] Colonel Meinertzhagen, British Chief Political Officer in Syria and Palestine, probably summarized these feelings best in a report of 31st March 1920 to the British Foreign Secretary, Lord Curzon:

> It is not doubted that Zionism will and must succeed to the benefit of Palestine and all its inhabitants. Should the Arab, as is inevitable, fail to compete with a superior civilisation, and from his nature it is probable he will not compete, is it fair that Palestine with its undeveloped resources, should be refused progress because its inhabitants are incapable of it? The Arabs will be compelled under Zionism to enjoy increased prosperity and security . . . .[31]

2.3. CONTROVERSIES SURROUNDING THE BALFOUR DECLARATION

Nearly everything regarding the Declaration -issued against this backdrop- is highly controversial. Its status in international law, and the fact that Great Britain entered into other agreements, which did or may have applied to

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FOREIGN AFF. 424, 434 (1951), argues that Arab states should accept Israel as Israel only occupied "one hundredth" of the area in which Arabs had gained independence; accord JULIUS STONE, ISRAEL AND PALESTINE: ASSAULT ON THE LAW OF NATIONS (1981); he provides the same statistics (at 16), and concludes that any Arab right to self-determination had therefore been fulfilled (at 17-18). Some within in the British establishment may also have deluded themselves that, no matter what they did, the local population would prefer British rule to a return of the Ottomans. That is implied by what Sir Valentine Chirol, one-time *Times* journalist and British diplomat, wrote in 1922. In "Islam and Britain" [Sir Ignatius Valentine Chirol, *Islam and Britain*, 1 FOREIGN AFF. 48 (1923).] he acknowledges Arab disappointment at unfulfilled Allied promises (at 57-58), and specifically mentions Palestine, but goes on to state: "Hatred of the Turk as a ruler is stronger than the tendency to sympathize with him as a brother in the Faith."; some within the British Establishment also accused the Arabs of "ingratitude". The British having liberated them from the Turks, the Arabs would surely "not begrudge that small notch [Palestine]."; Macmillan attributes this statement to Foreign Secretary Balfour (*supra* note 12, at 432).

[29] Frankfurter, *supra* note 5, at 409-413, 415 (Frankfurter states that "no wise friend of Arab aspirations would seek to charge the Arab with responsibility for composing the delicate religious and racial problems in Palestine"); *see also* DAVID BEN-GURION, ISRAEL: YEARS OF CHALLENGE 14-15 (1964); Shlaim, *supra* note 9, at 11; Macmillan, *supra* note 12, at 431.

[30] Frankfurter, *supra* note 5, at 418; Winston Churchill, then Secretary of State for the Colonies and on a visit to Palestine in March 1921, remarked that he believed Jewish immigration into Palestine "will be good for the world, good for the Jews and good for the British. But we also think it will be good for the Arabs who dwell in Palestine . . . ."; reprinted in Ingrams, *supra* note 1, at 118-119 (PRO. CO. 733/2); Strawson, *supra* note 2, at 31-32.

[31] Colonel Meinertzhagen, Chief Political Officer in Syria and Palestine, to Lord Curzon, British Foreign Secretary, in a report of 31st March 1920 on the situation in Palestine; reprinted in Ingrams, *supra* note 1, at 82-83 (PRO. FO. 371/5034).

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Palestine, has led some to view the Declaration as invalid. Due to its ambiguous terms, attempts at interpreting the Declaration's actual meaning have caused even more controversies.

2.3.1. THE "TOO MUCH PROMISED" LAND

> The Palestine position is this.[32] If we deal with our commitments, there is first the general pledge to Hussein in October 1915, under which Palestine was included in the areas as to which Great Britain pledged itself that they should be Arab and independent in the future . . . . Great Britain and France -Italy subsequently agreeing- committed themselves to an international administration of Palestine in consultation with Russia, who was an ally at the time . . . . A new feature was brought into the case in 1917, when Mr. Balfour, with the authority of the War Cabinet, issued the famous declaration to the Zionists that Palestine should be the national home of the Jewish people . . . .[33]

2.3.1.1. SYKES-PICOT-AGREEMENT (1916)

In late 1915, the British and the French began negotiations on the fate of the Middle East in the aftermath of the First World War. Regarding Palestine, the British representative, Sykes, and the French negotiator Picot, achieved a compromise: two ports and a stretch of land, enabling the construction of a railway line to Mesopotamia, should become British-administered territory, while the rest of the territory was to be under an international regime.[34] In early 1916, both governments approved the Sykes-Picot-Agreement, but kept it secret. The Russians, in April 1916, also agreed to the outlines of the agreement.[35]

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[32] Prince, *supra* note 3, at 125; Woolbert, *supra* note 3, at 311 (quote in the paragraph's title).
[33] Lord Curzon, Lord President of the Council, member of the Inner War Cabinet and future British Foreign Secretary, at a meeting of the "Eastern Committee" (previously the Middle Eastern Committee) on 5 December 1918; Minutes of the meeting reprinted in Ingrams, *supra* note 1, at 48 (PRO. CAB. 27/24).
[34] Quigley, *supra* note 7, at 12-13; Kattan, *supra* note 6, at 40-41; Schneer, *supra* note 14, at 75-86; Barr, *supra* note 21, at 31.
[35] Quigley, *supra* note 7, at 13; Schneer, *supra* note 14, at 80; Barr, *supra* note 21, at 60.

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When the British government started contemplating its expression of support for Zionist intentions in Palestine, it was indeed the Sykes-Picot-Agreement, and possible adverse French reaction to any such venture, that worried officials most.[36] However, Zionist supporters managed to enlist French support. On 4th June 1917, Cambon, a leading official in the French Foreign Ministry, gave a Zionist representative a written confirmation that France felt "sympathy" for the Zionist endeavours in Palestine.[37] Subsequently, the Sykes-Picot-Agreement no longer was seen as an obstacle to British support of Zionism.[38]

2.3.1.2. MCMAHON-HUSSEIN CORRESPONDENCE (1915/1916)

As mentioned earlier, the British government never took the possibility of Arab opposition to the Declaration seriously. Nevertheless, the correspondence of 1915/1916 between the British High Commissioner in Egypt, McMahon, and the Sharif Hussein of Mecca -who was viewed as one of the main leaders of Arab resistance against Ottoman rule- was to trouble the British government for many decades, as it dealt with post-war Arab independence.[39]

Indeed, it has been argued frequently that the Balfour Declaration is invalid because the British had already promised the Arabs that Palestine would be part of an independent Arab state's territory. In exchange for Arab support against the Ottomans, the British had promised the Arabs independence. Up to this day it is, however, highly controversial whether the territory promised to Hussein included Palestine or not.[40]

Based mainly on a letter by McMahon of 24th October 1915,[41] many argue that Palestine was included in the territory to be under Arab rule.[42]

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[36] Fromkin, *supra* note 9, at 291, 297; Schneer, *supra* note 14, at 159-160, 218-219, 232-236.
[37] Fromkin, *supra* note 9, at 292-293; Quigley, *supra* note 7, at 18; he mentions a secret agreement between British Prime Minister Lloyd George and the French in December 1918, whereby Palestine should be British.
[38] Young, *supra* note 12, at 391-392; he also mentions Foreign Office efforts to convince the French; Schneer, *supra* note 14, at 86.
[39] Report of a Committee set up to consider certain correspondence between Sir Henry McMahon and The Sharif of Mecca in 1915 and 16, Cmd. 5974, (March 16, 1939), http://www.gwpda.org/1916/mcmahon_sharif.html as evidenced by the Committee set up to investigate the correspondence in the late 1930s); Strawson, *supra* note 2, at 55-56.
[40] Schneer, *supra* note 14, at 64, 74.
[41] For a translated version of the letter, see http://www.jewishvirtuallibrary.org/jsource/History/hussmac1.html>. It is the two statements: "The two districts of Mersina and Alexandretta and portions of Syria lying to the west of the

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Among others, a British Foreign Secretary and various civil servants in the Foreign Office supported that view.[43] Furthermore, in June 1922, a large majority in the House of Lords passed a motion, which declared the Palestine Mandate "inacceptable" because, among other things, "it directly violates the pledges made by His Majesty's Government to the people of Palestine in the Declaration of October, 1915".[44] This provides a strong indication that many in the House of Lords also believed Palestine to have been included in the territory promised to Hussein.

Officially, the British government always maintained that Palestine was not part of the territory promised to the Arabs, but had instead been explicitly excluded.[45] McMahon himself,[46] who is usually given credit for having

districts of Damascus, Homs, Hama and Aleppo cannot be said to be purely Arab, and should be excluded from the limits demanded" and "Subject to the above modifications, Great Britain is prepared to recognize and support the independence of the Arabs in all the regions within the limits demanded by the Sherif of Mecca" which have led to the controversy. It has remained in dispute whether Palestine was excluded from the area in which Arabs were to be independent or not.

[42] *See, e.g.,* Hillary Harry St. John Bridger Philby, *The Arabs and the Future of Palestine*, 16 FOREIGN AFF. 156, 157 (1937), (he claims that only Aden was excluded from Arab independence in the correspondence); Prince, *supra* note 3, at 125; implicitly Woolbert, *supra* note 3, at 311 ("contradictory promises during the World War"); Günther Weiß, *Die Entwicklung der Palästina-Frage seit dem Peel-Bericht*, 9 ZAöRV 382, 416-17 (he offers a linguistic interpretation based on Turkish and Arab terms for "district", and concludes that the Arabs were justified in assuming Palestine was included); and *supra* note 17, at 148; DAVID HIRST, THE GUN AND THE OLIVE BRANCH 160 (2nd ed. 1984); Allain, *supra* note 17, at 78; Hadawi, *supra* note 28, at 11-14; Watrin, *supra* note 21, at 60; Strawson, *supra* note 2, at 3-4; Kattan, *supra* note 6, at 45-46, 98-111.

[43] Lord Curzon, Lord President of the Council, member of the Inner War Cabinet and future British Foreign Secretary, at a meeting of the "Eastern Committee" (previously the Middle Eastern Committee) on 5th December 1918; he declared that Palestine was "included in the areas as to which Great Britain pledged itself . . . . in a general pledge to Hussein in October 1915 . . . . that they should be Arab and independent in future"; Minutes of the meeting reprinted in Ingrams, *supra* note 1, at 48 (PRO. CAB. 27/24); J. RUSSELL GAINSBOROUGH, THE ARAB-ISRAELI CONFLICT: A POLITICO-LEGAL ANALYSIS 5 (1986) he refers to a note on a map (Foreign Office Minute of 1918, also mentioned by Kattan, *supra* note 6, at 40), PRO. FO. 371/4352, which states: "Palestine was implicitly included in King Hussein's original demands and was not explicitly excluded in Sir H. McMahon's letter of 24.10.1915. We are therefore, presumably, pledged to King Hussein by this letter that Palestine shall be 'Arab' and 'independent'"; a further memorandum, prepared by the Political Intelligence Department at the Foreign Office in preparation for the negotiations at Versailles states: "With regard to Palestine, H.M.G. are committed by Sir Henry McMahon's letter to the Sherif on October 24th, 1915, to its inclusion in the boundaries of Arab independence"; see: *Light on Britain's Palestine Promise*, THE TIMES, Apr. 17, 1964, at 15; also quoted in Kattan, *supra* note 6, at 38 (FO. 608/92); Quigley, *supra* note 7, at 11-12; Frankfurter, *supra* note 5, at 414-415; though a leading Zionist, he only mentions the controversy without expressing an opinion; he only claims it is in the Arabs' own best interest not to rule Palestine.

[44] Hansard, Palestine Mandate, H.L. Deb. vol 50 cc994-1033, c994; (June 21, 1922).

[45] Ben-Gurion, *supra* note 29, at 11; Quigley, *supra* note 7, at 12.

[46] McMahon (in 1937); quoted in "*Report of a Committee set up to consider certain correspondence between Sir Henry McMahon and The Sharif of Mecca in 1915 and 16*", 16th March 1939, Cmd. 5974, para. 13 e, *supra* note 39: "I feel it is my duty to state, and I do so, definitely and emphatically, that it was not intended by me in giving the pledge to King Hussein to include Palestine in the area in which Arab independence was promised".

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expressed himself as vaguely as possible in his correspondence with Hussein, supported this view.[47] In later times, nevertheless, the British government somewhat modified its position regarding the promises made.

In the Arab-U.K. Committee Report of 1939, the U.K. representatives declared:

> 16. Both the Arab and the United Kingdom representatives have tried (as they hope with success) to understand the point of view of the other party, but they have been unable to reach agreement upon an interpretation of the Correspondence, and they feel obliged to report to the conference accordingly.
>
> 17. The United Kingdom representatives have, however, informed the Arab representatives that the Arab contentions, as explained to the committee, regarding the interpretation of the Correspondence, and especially their contentions relating to the meaning of the phrase "Portions of Syria lying to the west of the districts of Damascus, Hama, Homs and Aleppo", have greater force than has appeared hitherto.
>
> 18. Furthermore, the United Kingdom representatives have informed the Arab representatives that they agree that Palestine was included in the area claimed by the Sharif of Mecca in his letter of the l4th July, 1915, and that unless Palestine was excluded from that area later in the Correspondence it must be regarded as having been included in the area in which Great Britain was to recognise and support the independence of the Arabs. They maintain that on a proper construction [sic] of the Correspondence Palestine was in fact excluded. But they agree that the language in which its exclusion was expressed was not so specific and unmistakable as it was thought to be at the time. [48]

Faced with this controversy, the British opted for a compromise regarding Palestine, which resulted in its later partition and the creation of Trans-Jordan. In his White Paper of 1922, Colonial Secretary Winston Churchill already outlined the partition in the following terms:

[47] Barr, *supra* note 21, at 22-29.
[48] "Report of a Committee set up to consider certain correspondence between Sir Henry McMahon and The Sharif of Mecca in 1915 and 16", 16 March 1939, Cmd. 5974, paras. 16-18 (supra note 39).

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> With reference to the Constitution which it is now intended to establish in Palestine, the draft of which has already been published, it is desirable to make certain points clear. In the first place, it is not the case, as has been represented by the Arab Delegation, that during the war His Majesty's Government gave an undertaking that an independent national government should be at once established in Palestine. This representation mainly rests upon a letter dated the 24th October, 1915, from Sir Henry McMahon, then His Majesty's High Commissioner in Egypt, to the Sherif of Mecca, now King Hussein of the Kingdom of the Hejaz. That letter is quoted as conveying the promise to the Sherif of Mecca to recognise and support the independence of the Arabs within the territories proposed by him. But this promise was given subject to a reservation made in the same letter, which excluded from its scope, among other territories, the portions of Syria lying to the west of the District of Damascus. This reservation has always been regarded by His Majesty's Government as covering the vilayet of Beirut and the independent Sanjak of Jerusalem. The whole of Palestine west of the Jordan was thus excluded from Sir Henry McMahon's pledge. [49]

The precise meaning of the McMahon-Hussein-correspondence has remained controversial.[50] The feeling of betrayal on the Arab side, caused by the differing interpretations of the McMahon-Hussein correspondence, certainly seems justified, when it is considered that, privately, many British officials agreed with the Arab interpretation.[51]

Nevertheless, this discussion is, as far as international law is concerned, largely irrelevant. As will be explained shortly, the fact that Palestine later was categorized as an "*A*"-Mandate, and as such was subject to Article 22 (4) of the Covenant and the Palestine Mandate (hereinafter the Mandate), makes this controversy obsolete.[52]

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[49] Winston Churchill, "The British White Paper", (June 3, 1922).
[50] Schneer, *supra* note 14, at 64-74; Tom Segev, *Mohammed und Herr Cohen*, SPIEGEL GESCHICHTE 82, 83 (2011).
[51] Chirol, *supra* note 28, at 57; he states: "The dream of a great Arab state which the Allies encouraged by their lavish promises during the war has vanished into thin air with the separate mandates which Britain and France agreed to confer upon themselves".
[52] According to Article 20 (2) of the Covenant, the obligations under the Covenant took precedence over prior obligations that were contrary to its provisions. Member states were to extricate themselves from such obligations. Furthermore, there are doubts as to Britain's right to dispose of

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2.3.2. INTERNATIONAL LEGAL STATUS OF THE BALFOUR DECLARATION

This leads on to the Balfour Declaration's status in international law. Some have argued that it represented a binding agreement between the Allies and the Zionists. In exchange for Zionist support during the First World War, the Allies had agreed to provide the Jewish people with a national home.[53] The latter contention is based on American government approval of the Declaration's text prior to the British government's issuance, while the French and Italian governments expressed their support in February and May 1918, respectively.[54]

However, there can be no doubt that the Declaration did not have any status in international law.[55] The Allies may have generally approved the text of the Declaration. Nevertheless, as the text evidences, it is only "His Majesty's Government" making any pledges -whatever their content may be. Furthermore, the British were making pledges regarding a territory they had not even occupied at the time.[56] Palestine was still Ottoman-ruled, and the outcome of the First World War was still uncertain.[57]

Moreover, states do not enter into public international law obligations in what was formally a letter to an individual, even if that person was prominent within the Zionist movement.[58] Furthermore, the Zionists at that

territory it had not even yet occupied, and as to Hussein's right to represent the Arabs. In that sense, the McMahon-Hussein Correspondence suffers from similar defects as the Declaration (which will be explained shortly).

[53] Murlakov, *supra* note 4, at 59-61; W. T. Mallison Jr., The Zionist-Israel Juridical Claims to Constitute The Jewish People Nationality Entity and to Confer Membership in it: Appraisal in Public International Law, 32 GEO. WASH. L. REV. 983, 1002-1005 (1963) (although he limits the obligation to Great Britain).

[54] *See Palestine Royal Commission Report*, July 1937, Cmd. 5479, 22, Chapter II, para. 14; https://palestinianmandate.files.wordpress.com/2014/04/cm-5479.pdf; Leonard Stein, *The Jews in Palestine*, 4 FOREIGN AFF. 415, 420 (1926); Strawson, *supra* note 2, at 45; Owen, *supra* note 15, at 428; Keay, *supra* note 9, at 79.

[55] Dunsky, *supra* note 25, at 167; Frankfurter, *supra* note 5, at 414 ("The Mandate explicitly recited the Balfour Declaration . . . . Thus was the Balfour Declaration made part of the law of nations"); Allain, *supra* note 17, at 73, 78; Shabtai Rosenne, *Directions for a Middle East Settlement - Some Underlying Legal Problems*, 33 L. & CONTEMP. PROBS. 44, 48 (1968) ("legal status . . . . may be open to discussion"); Gendell, Stark, *supra* note 6, at 217; they seem to disagree.

[56] *See* Muhammad H. El-Farra, *The Role of the United Nations vis-à-vis the Palestine Question,* 33 L. & CONTEMP. PROBS. 68, 68 (1968); Mallison, *supra* note 53, at 1002; Linowitz, *supra* note 6, at 522; Kattan, *supra* note 6, at 44; Strawson, *supra* note 2, at 35; Shlaim, *supra* note 9, at 4, 8.

[57] *See* DAWOUD EL-ALAMI & DAN COHN-SHERBOK, THE PALESTINE-ISRAELI CONFLICT 144 (3rd ed. 2008); Kattan, *supra* note 6, 44.

[58] Strawson, *supra* note 2, at 35; Kattan, *supra* note 6, at 58-59. Even if the Declaration were construed to be an agreement between the British and the Zionists, it would not be governed by public international law. Its status would be similar to that of a concession granted by a state to a private company. The Zionist organization -certainly at that time- had no status in public international law. Regarding concessions, also see Anglo-Iranian Oil Co. Case (United Kingdom v.

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time were not anything approaching a majority among the Jews worldwide. Therefore, their right to represent the Jewish world population in general must be disputed.[59]

The only conclusion can therefore be that the Balfour Declaration is "not a legal document, and has no standing in international law."[60]

2.3.3. INTERPRETATION OF THE TEXT

Due to its vagueness, the interpretation of the Balfour Declaration has always been extremely controversial. Although the Declaration itself never had any "Standing in international law", it, nevertheless, was later included in the Mandate for Palestine, which was approved by the League of Nations. This makes it necessary to examine more closely what was actually meant by the phrases "His Majesty's Government view with favour the establishment in Palestine of a national home for the Jewish people" and "it being clearly understood that nothing shall be done which may prejudice the civil and religious rights of existing non-Jewish communities in Palestine".[61]

Some have claimed that the wording of the Declaration can only mean that Palestine in its entirety (including what is nowadays Jordan) was to become *the* Jewish National Home, resulting in the creation of a "Jewish Commonwealth".[62] The so-called "Safeguard Clause", dealing with the non-

Iran), Judgement, 1952 I.C.J. Rep. 93, 111-113 (July 22). The I.C.J. declined its jurisdiction also on the basis that the Concession granted to the Anglo-Iranian Oil Co. by Iran did not create any rights as far as the United Kingdom was concerned.

[59] Mallison, *supra* note 53, at 1004 (also quoting Weizmann, who acknowledged that fact); *see also* Anis F. Kassim, *The Palestine Liberation Organization's Claim to Status: A Juridical Analysis under International Law*, 9 Denv. J. Int'l L. & Pol'y 1, 13-14 (1980); he rightly points out that the first time the Zionist Organization was internationally recognized as a public body was in the Mandate which established the Jewish Agency.

[60] Dunsky, *supra* note 25, at 167; Mallison, *supra* note 53, at 1030; Mallison disagrees. He argues that the Declaration has become part of customary international law. This position can hardly be reconciled with his own interpretation of the Declaration (he concludes that it contained only a "political promise clause").

[61] "The Balfour Declaration", supra *note* 8.

[62] Howard Grief, *Legal Rights and Title of Sovereignty of the Jewish People to the Land of Israel and Palestine under International Law*, NATIV Online (2004), http://www.acpr.org.il/English-Nativ/02-issue/grief-2.htm; 1-12, 1, 2; Dunsky, *supra* note 25, at 170; Dunsky makes a related argument; he claims that the mandates system meant that the international community had made "an explicit decision" that the Jews "were to achieve self-determination" in the part of Palestine that was not Trans-Jordan. This seems contradictory, given Dunsky's argument in the previous sentence, according to which the concept of self-determination at that time was "purely political ...and not binding".

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Jewish communities, is argued to obviously envisage their future minority status within a new Jewish entity.[63]

The then Prime Minister, Lloyd George, supported this interpretation - in general terms. Before the "Peel Commission" in 1937, he declared, when giving evidence:

> The idea was, and this was the interpretation put upon it at the time, that a Jewish State was not to be set up immediately by the Peace Treaty without reference to the wishes of the majority of the inhabitants. On the other hand, it was contemplated that when the time arrived for according representative institutions to Palestine, if the Jews had meanwhile responded to the opportunity afforded them by the idea of a national home and had become a definite majority of the inhabitants, then Palestine would thus become a Jewish Commonwealth. [64]

On the other hand, in his White Paper of 1922, Winston Churchill, the Colonial Secretary, had declared:

> Unauthorized statements have been made to the effect that the purpose in view is to create a wholly Jewish Palestine. Phrases have been used such as that Palestine is to become "As Jewish as England is English." His Majesty's Government regard any such expectation as impracticable and have no such aim in view. Nor have they at any time contemplated, as appears to be feared by the Arab Delegation, the disappearance or the subordination of the Arabic population, language or culture in Palestine. They would draw attention to the fact that the terms of the Declaration referred to do not contemplate that Palestine as a whole should be converted into a Jewish National Home, but that such a Home should be founded in Palestine.[65]

Later, when the troubles in Palestine were threatening to overwhelm Britain, the British government sought to distance itself even further from the view that the Balfour Declaration had created any definite obligations:

[63] Linowitz, *supra* note 6, at 523.
[64] Lloyd George, quoted in *Palestine Royal Commission Report*, July 1937, Cmd. 5479, 24, Chapter II, para. 20; *supra* note 54; Shlaim, *supra* note 9, at 14.
[65] Winston Churchill, "*The British White Paper*", *supra* note 49.

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> The Balfour Declaration, in itself a compromise document, was not expressed in definitive political terms. It was a gesture, the expression of a hope then existing that the Jews and Arabs would compose their differences and eventually coalesce into a single commonwealth united in Palestinian citizenship. That evolution had not taken place . . . .[66]

A literal understanding of the Declaration would seem to imply that Winston Churchill's interpretation -as described in his White Paper of 1922- is correct.[67] Neither is a "Jewish state" mentioned in the Declaration, nor is Palestine described as "the" Jewish National Home. [68] As both Shlaim and Strawson point out, at that time the term "national home" -in contrast to the word "state"- had no defined political or legal meaning whatsoever.[69] When, on the other hand, assessing Lloyd George's contrary interpretation it is necessary to bear his strong pro-Zionist bias in mind.

Certainly, Lord Curzon, also a member of the Cabinet at the time it passed the Declaration, and by now Foreign Secretary, took a different view from that of the Prime Minister. When presented with a draft of the Mandate, which included the phrase "Will secure the establishment of a Jewish National Home and a self-governing Commonwealth", Curzon responded by commenting: "'Development of a self-governing Commonwealth'. Surely most dangerous. It is a euphemism for a Jewish State, the very thing they accepted and that we disallow.[70]

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[66] William Ormsby-Gore, Secretary of State for the Colonies, before the *Permanent Mandates Commission* in 1937; Thirty-Second (Extraordinary) Session, Devoted to Palestine, Held at Geneva from July 30th-August 18th, 1937, twenty-second meeting; https://unispal.un.org/DPA/DPR/unispal.nsf/0/FD05535118AEF0DE052565ED0065DDF7.

[67] Kattan, *supra* note 6, at 5; without offering any explanation, Dunsky, however, views this interpretation as "unlikely" (*supra* note 25, at 173).

[68] Collins, *supra* note 4, at 157; Kattan, *supra* note 6, at 59-63; Strawson, *supra* note 2, at 36; Shlaim, *supra* note 9, at 14, 23.

[69] Shlaim, *supra* note 9, at 14 ("never clearly defined and . . . . no precedent in international law"); Strawson, *supra* note 2, at 36 ("it [the term 'national home'] was unknown in international law" and "in political discourse"); Kattan, *supra* note 6,at 61-62; he agrees, and goes on to argue that the Zionist drafters of the first version of the Declaration deliberately avoided the term "state", because they realized that any such commitment would be rejected by the British government.

[70] Comment by Lord Curzon on a draft of the Mandate, March 1920; reprinted in Ingrams, *supra* note 1, at 94 (PRO. FO. 371/5199); Eric Forbes Adam (Diplomatic Service) responded to this comment on 18th March 1920, by stating that "the use of the phrase did not, to our mind, imply any acceptance in the mandate of the Jewish idea that the Palestinian state set up by the mandate would ever become a Jewish state"; reprinted in Ingrams, *ibid*, 94-95 (PRO. FO. 371/5199).

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In the ensuing discussion, Curzon went on to point out that the creation of a Jewish State, if included in the Mandate, was "Contrary to every principle upon which we have hitherto stood, I at any rate cannot accept it."[71]

Further illumination is provided when the draft "Declarations" *not* adopted by the British government before the Balfour Declaration was issued are examined. The British cabinet actually had already rejected four previous drafts before approving the Balfour Declaration on 31st October 1917.[72] The *first* draft (July 1917), prepared by Zionists, was comparatively straightforward. It provided that the British government "accepts the principle that Palestine should be reconstituted as the National Home of the Jewish people".[73] No safeguard clause was included. The *second* draft (August 1917), authored by Balfour, was more or less identical to the Zionist draft. Milner's *third* draft (August 1917) already included a much weaker statement which declared that the British government "accepts the principle that every opportunity should be afforded for the establishment of a home for the Jewish people in Palestine". However, a safeguard clause still was not included.

By the time the *fourth* draft (the so-called "Milner-Amery Draft") was presented on 4th October 1917, the original, Zionist proposal had been "watered down" considerably.[74] In it, the British government only "viewed with favour the establishment in Palestine of a national home for the Jewish race". For the first time a safeguard clause protecting the "non-Jewish communities'" rights was included.[75] With two minor amendments this fourth draft was to become the Balfour Declaration.

It is therefore understandable that the Zionist leader Dr Weizmann described the Milner-Amery draft, more or less identical to the Declaration, as a "painful recession";[76] a comment which cannot be easily reconciled with the

[71] Response by Lord Curzon to minutes prepared by Eric Forbes Adam, 19 March 1920; reprinted in Ingrams, *supra* note 1, at 95 (PRO. FO. 371/5199).
[72] For the text of all four drafts, see: Leonard Stein, The BalFour Declaration, 664 (ACLS Humanities E-Book 2008) (1961); for evidence of the discussions within the British Cabinet, also see: Ingrams, *supra* note 1, at 7-18; Kattan, *supra* note 6, at 59-63; Strawson, *supra* note 2, at 29-30; Schneer, *supra* note 14, at 334-336, 339-341.
[73] Ingrams, *supra* note 1, at 9.
[74] Mallison, *supra* note 53, at 1014; Kattan, *supra* note 6, at 62-63.
[75] Ingrams, *supra* note 1, at 12-13 (PRO. CAB. 23/4).
[76] Dr Chaim Weizmann, as quoted by Mallison, *supra* note 53, at 1013; and Kattan, *supra* note 6, at 61; Fromkin, *supra* note 9, at 297; Fromkin describes the final version as a "much diluted" version

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arguments put forward by those who claim that the Balfour Declaration had clearly promised the Zionists the creation of a Jewish state. The British government only "favoured" the establishment of "*a*" national home for the Jews. Any "reconstitution" of such a home that might have implied acknowledgement of ancient Jewish rights was not mentioned, and, finally, the safeguard clause in favour of the "non-Jewish communities" was included.[77]

Considering this evolution of the Balfour Declaration, it becomes clear that the British cabinet in its totality -no matter what Lloyd George's and Balfour's intentions had been- was at pains to avoid any precise legal obligations, and certainly did not want to guarantee the future establishment of a Jewish State or Commonwealth in Palestine.[78] Obviously, the British government would not have wished to antagonize the local inhabitants unnecessarily at a time when the planning for a British invasion of Palestine was in its last stages.[79]

Schneer adds another twist. According to him, leading British politicians were actually willing to drop the pledges in the Balfour Declaration towards the end of the First World War. In an effort to persuade Turkey to desert the Central Powers, negotiations with individual Turkish politicians ensued in early 1918, during which Lloyd George seemed willing to grant Turkey at least nominal sovereignty over Palestine.[80] That is why Schneer has

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and claims Weizmann was unhappy with the result.

[77] Strawson, *supra* note 2, at 36.

[78] Allain, *supra* note 17, at 79; Owen, *supra* note 15, at 427, 428; he (a "George Lloyd" Liberal M.P. in 1929, and biographer of Lloyd George) points out that "rifts" developed in the War Cabinet as far as the Declaration was concerned which were to continue for a long time afterwards. One of the consequences being that the Declaration did not answer the question what British policy actually was; *see* Norman Bentwich, *The Mandate for Palestine*, 10 BRIT. Y.B INT'L L. 137, 139 (1929), he states: "A national home connotes a territory in which a people, without receiving the rights of political sovereignty, has, nevertheless a recognized legal position . . . ."; this statement by Bentwich is quoted by Frankfurter (President of the American Zionist Organization), and described as the comment of a "leading authority" (*supra* note 5, at 417); Omar M. Dajani, *Stalled Between Seasons: The International Legal Status of Palestine During the Interim Period*, 26 DENV. J. INT'L L. & POL'Y 27, 36-37 (1997); Mallison, *supra* note 53, at 1018; Mallison describes the Declaration as "having a very restricted political meaning"; Grief, *supra* note 62, at 2; Grief disagrees. Without providing any evidence, he argues that the British Cabinet had meant a "state" when it used the term "Jewish National Home"- a state that encompassed all of Palestine. However, there are only few who share Grief's extreme interpretation. Rather, the fact that the Holy Sites were situated in what was then Palestine makes it highly unlikely that the British Cabinet would have agreed to a Jewish state being created that was identical to Palestine (This assertion does, however, not necessarily preclude the argument -opposed here- that some kind of Jewish state was envisaged in Palestine, see above).

[79] Mallison, *supra* note 53, at 1014; Kattan, *supra* note 6, at 255.

[80] Schneer, *supra* note 14, at 347-361.

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concluded that Palestine, in fact, was promised "four times".[81] Nothing came of these negotiations, but the episode certainly does demonstrate that leading British politicians were not inhibited by any commitments undertaken in the Balfour Declaration.

The conclusion must therefore be that the Balfour Declaration did not include the promise of the creation of a Jewish state in Palestine.[82] Its content was more in line with the original Foreign Office sentiment, which was the establishment, in Palestine, of "a sanctuary for Jewish victims of persecution".[83] This view was shared within the U.S. State Department. In a memorandum of 22 September 1947, Loy Henderson wrote to the Secretary of State:

> We are under no obligation towards the Jews to set up a Jewish State. The Balfour Declaration and the Mandate provide not for a Jewish State but for a Jewish national home. Neither the United States nor the British Government has ever interpreted the term "Jewish national home" to be a Jewish national state.[84]

Nevertheless, and undoubtedly, a promise to allow Jewish immigration into Palestine in the case of British occupation was made.

How the British government wanted to reconcile the creation of a Jewish national home with its desire not to prejudice the existing "non-Jewish communities'" rights remains open to question. All the indications are that the possible consequences were not analysed in detail, and that the Balfour Declaration was a politicians' compromise: as vague as possible in order to please as many as possible, if only superficially. Accordingly, Kermit Roosevelt, a Middle East expert who worked for the C.I.A., described the Declaration's content as being "of the poetical obscurity of the Delphic Oracle" due to its many "deliberate ambiguities".[85] Certainly, detailed concepts of how to proceed

[81] Schneer, *supra* note 14, at 368.
[82] This is further evidenced by Frankfurter's (President of the American Zionist Organization) comment in 1930 (*supra* note 5, at 415): "But authoritative Jewish demand is not for a Jewish state; it does not ask to govern others."; Macmillan, *supra* note 12, at 427-428; she points out that the British government "insisted repeatedly" that a national home "did not mean a state".
[83] Mallison, *supra* note 53, at 1012.
[84] *The Director of the Office of Near Eastern and African Affairs (Henderson) to the Secretary of State*, September 22nd, 1947; U.S. Department of State, F.R.U.S., 1947, The Near East and Africa, 1947, 1153-1158, 1157.
[85] Kermit Roosevelt, quoted in Keay, *supra* note 9, at 80.

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in Palestine after the war are nowhere to be found which, in turn, by 1939, had led to eleven British commissions having been sent to Palestine in order to figure out how to reconcile the conflicting aims of the Balfour Declaration.[86] In the end, Britain could only acknowledge its failure to do so. Lord Cecil was to be proved right in his prediction, made during a discussion on who should administer Palestine, that "whoever goes there will have a poor time."[87]

3. BRITISH OCCUPATION OF PALESTINE (1917-1923)

By Christmas 1917, the British had occupied Jerusalem. General Sir Edmund Allenby placed the area under military administration. Military rule in the "Occupied Enemy Territory" lasted until 30th June 1920.[88] Regarding Jewish immigration into Palestine, a ban was in place, which the Ottoman rulers had imposed.[89] However, Hebrew immediately became one of Palestine's official languages, which caused an influx of Jewish inhabitants into the local civil service.[90] In Britain, meanwhile, the "Zionist Commission" was set up with the task of advising the British administration in Palestine.[91] It soon became an "Administration within an Administration."[92]

[86] Kattan, *supra* note 6, at 44; Shlaim, *supra* note 9, at 17-19.
[87] Lord Robert Cecil, Assistant Secretary of State, at a meeting of the "Eastern Committee" (previously the Middle Eastern Committee) on 5th December 1918; Minutes of the meeting reprinted in Ingrams, *supra* note 1, at 48-50, 50 (PRO. CAB. 27/24).
[88] *See* Norman Bentwich, *Mandated Territories: Palestine and Mesopotamia (Iraq)*, 2 Brit. Y.B. Int'l L. 48, 50 (1921); *see also* Norman Bentwich, *The Legal Administration of Palestine Under the British Military Occupation*, 1 Brit. Y.B. Int'l L. 139-148 (1920).
[89] A law from 1882 prohibited all foreign Jews from visiting Palestine, except as pilgrims. The sale of land to foreign Jewish settlers was prohibited in 1883, and, in 1892, the Department of Land Registration prohibited the sale of any land to any Jews. The laws stayed in force until the end of the Ottoman Empire. However, they were not very successfully enforced. For more details, see: Mim Kermal Öke, *The Ottoman Empire, Zionism, And The Question of Palestine (1880-1908)*, 14 Int. J. Middle E. Stud. 329-341 (1982).
[89] Storrs, *supra* note 27, at 302, 354.
[90] Storrs, *supra* note 27, at 302, 354.
[91] "Plans Zionist Commission, England will aid Repatriation of Jews and Restoration"; *The New York Times*, (Feb. 13, 1918)
http://query.nytimes.com/mem/archivefree/pdf?_r=1&res=9807EED7103FE433A25750C1A9649C946996D6CF&oref=slogin.
[92] Letter by General Bols, Chief Administrator in Palestine, to the Foreign Office (1920); reprinted in Ingrams, *supra* note 1, at 85-86 (PRO. FO. 371/5119).

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A Civil Administration took over subsequent to a Resolution passed at the San Remo Conference[93] on 25th April 1920,[94] which stated that Britain should be the mandatory power for Palestine. While the Resolution included the provisions of the Balfour Declaration, it also noted that the terms of the mandate had to be approved by the Council of the League of Nations. This approval was received on 24th July 1922, and the Mandate for Palestine came into effect on 29th September 1923. Nevertheless, based on the San Remo Resolution, the Ottoman ban on Jewish immigration was lifted by the Civil Administration under High Commissioner Sir Herbert Samuel.

The decision to introduce an immigration law,[95] and to simplify land transfer[96] in Palestine "in anticipation of the definite granting of the Mandate" was not simply "imperfect in its legal foundation" -as the Legal Secretary of the Government of Palestine (later Attorney-General) Bentwich admitted in 1922.[97] Rather, it contravened Article 43 of the 1907 Hague Regulations,[98] which requires the occupier of "the territory of the hostile state" to respect "unless absolutely prevented the laws in force of the country". These Ottoman laws included a ban on Jewish immigration and on transfers of land to foreign Jews.[99] In 1920, the Chief Administrator in Palestine, General Bols, acknowledged the legal difficulties:

> This Administration has loyally carried out the wishes of His Majesty's Government, and has exceeded in doing so the strict

[93] The San Remo Conference was a meeting of the *Allied Supreme Council* (Britain, France, Italy, and Japan). The United States insisted on not being referred to as an "ally", but instead preferred the term "Associated Power". It should be noted that the United States never declared war on the Ottoman Empire, so that it was also not represented in San Remo.

[94] For the text of the San Remo Resolution, see http://ecf.org.il/media_items/299.

[95] *Immigration Ordinance* (1920).

[96] *See Land Transfer Ordinance* (1920), *Mahlul Land Ordinance* (1920) and *Mawet Land Ordinance (*1921).

[97] Bentwich, *supra* note 88, at 50, 52; Berriedale Keith, *Mandates*, 4 J. Comp. LegiS. & Int'l L., 71, 72-73 (1922); he describes the legal situation in the "*A*"- Mandates in 1922 as "anomalous" due to the lack of a peace treaty with Turkey: despite Britain's "lack of title", the British were "exercising large powers of government", irrespective of the fact that British and French rights on Turkish territory only "rest on the fact of occupation and conquest"; Elihu Lauterpacht, *The Contemporary Practice of the United Kingdom in the Field of International Law- Survey and Comment, IV, State Territory*, 6 Int'l Comp. L. Q. 513, 514 (1957); Malcolm M. Lewis, *Mandated Territories, Their International Status*, 39 L.Q. Rev 458, 460 (1923) ("somewhat anomalous").

[98] Convention (IV) respecting the Laws and Customs of War on Land and its annex: Regulations concerning the Laws and Customs of War on Land (Hague Convention), Oct. 18, 1907; 36 Stat. 2277.

[99] For details, see note 89; Öke, *supra* note 88.

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> adherence to the laws governing the conduct of Military Occupant of Enemy Territory, but this has not satisfied the Zionists . . . .[100]

In his subsequent recollections of his time in Palestine, the Military Governor in 1917, Roland Storrs,[101] was even more forthright as to the "admitted departure from the Laws and Usages of War":[102] "The Military Administration notably contravened the Status quo, in the matter of Zionism . . . . For these deliberate and vital infractions of military practice O.E.T.A. [Occupied Enemy Territory Administration] was criticized both within and without Palestine."[103]

Furthermore, Turkey, successor to the Ottoman Empire, never ratified the original peace treaty, the *Treaty of Sèvres* of 10th August 1920. The final peace treaty, the *Treaty of Lausanne*, was concluded only on 24th July 1923. Therefore, Palestine, at the time of the enactment of the new immigration and land transfer laws, was still "territory of the hostile state". The British government subsequently acknowledged that only ratification of the *Treaty of Lausanne* in August 1924 "regularized the international status of Palestine as a territory detached from Turkey and administered under a Mandate entrusted to His Majesty's Government."[104]

That there was no "absolute" necessity to act[105] in fulfilment of the Balfour Declaration before the League of Nations had approved the envisaged Mandate and it had come into effect is self-evident. British measures to enable the implementation of the Balfour Declaration, undertaken before the ratification of the *Treaty of Lausanne*, were therefore inconsistent with international law.[106]

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[100] Letter by General Bols, Chief Administrator in Palestine, to the Foreign Office (1920); reprinted in Ingrams, *supra* note 1, at 85-86 (PRO. FO. 371/5119).
[101] Ronald Storrs was Military Governor of Jerusalem between 1917 and 1920, and then Civil Governor between 1920 and 1926.
[102] Storrs, *supra* note 27, at 354.
[103] Storrs, *supra* note 27, at 301; Storrs goes on to point out that the British Administration in Palestine was supposed to act as a "Military Government and not as Civil Reorganizers", and would consequently have been obliged to "administer the territory as if it had been Egypt."
[104] *Report of His Britannic Majesty's Government on the Administration under Mandate of Palestine and Transjordan for the year 1924*, Section I (Dec. 31, 1924); for full text also see: https://unispal.un.org/DPA/DPR/unispal.nsf/0/A87D21F4E57F2D0F052565E8004BACE0.
[105] Hague Convention, *supra* note 98, art. 43.
[106] Allain, *supra* note 17, at 80-81; Macmillan, *supra* note 12, at 435; referring to the difficulties in concluding a peace treaty with "Ottoman Turkey", she continues: "The British simply carried on as though Palestine was officially theirs."

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4. THE PALESTINE MANDATE

4.1. THE MANDATES SYSTEM

The introduction of the mandates system in the aftermath of the First World War was a legal novelty,[107] usually attributed to the South African General Smuts, member of the Imperial War Cabinet.[108] Although similar to a protectorate in some respects, the mandate had unique implications as far as the mandatory power was concerned, as specific obligations towards the League of Nations were imposed.[109]

From the outset, the mandates system was very controversial. Many, especially in the United States, viewed the system as nothing more than a "cloak for annexation" by the European powers.[110] Besides isolationism, this was one of the main reasons the United States refused to take on the Palestine Mandate -as suggested by some-, and turned down the mandate for Armenia.[111]

4.1.1. SELF-DETERMINATION AND PRESIDENT WILSON

In 1916, Wilson had outlined his vision of national self-determination, when he declared in an address to the *League to Enforce Peace* "that every people has a right to choose the sovereignty under which they shall live." He emphasized his beliefs when he added that "no peace can last or ought to last which does not accept the principle that governments derive all their just powers from the

[107] Grief, *supra* note 62, at 1; Henry Goudy, *On Mandatory Government in the Law of Nations*, 1 J. COMP. LEGIS. & INT'L L., no. 3, 1919 at 175; Keith, *supra* note 97, at 72; Donald S. Leeper, *International Law: Trusteeship Compared with Mandate*, 49 MICH. L. REV. 1199-1210, 1199 (1951); Lewis, *supra* note 97, at 458; Mark Carter Mills, *The Mandatory System*, 17 Am. J. Int'L. L. 50, 50-62.

[108] Based on his "Practical Suggestion" of December 1918; Anghie, *supra* note 21, at 119-120; Quigley, *supra* note 7, at 20-22; Strawson, *supra* note 2, at 37-39; Owen, *supra* note 15, at 549.

[109] *See* Percy E. Corbett, *What is the League of Nations?*, 5 BRIT. Y.B. INT'L L. 119, 130 (1924); Lewis, *supra* note 97, at 459, 474.

[110] Mills, *supra* note 107, at 54; he claims that the U.S. Secretary of State Lansing shared that view; Watrin, *supra* note 21, at 61; Keith, *supra* note 97, at 74; Keith claims that many mandatory powers' governments assumed that the "C"-Mandates allowed "virtual annexation", and agrees with that assessment (at 76); 75 (American attitude); Bassiouni, *supra* note 25, at 34; he describes the mandate system in Palestine as a "colonial regime"; Corbett, *supra* note 109, 133; Corbett cites M. Rolin (later to be a judge at the *Permanent Court of International Justice*, 1931-1936) as stating that the mandates system was a disguise for annexation; Goudy, *supra* note 107, at 175; Philby, *supra* note 42, at 158; Philby argues that the "system of Mandates" differed "only in theory from annexation"; Stefan Tolin, *The Palestinian People and Their Political, Military and Legal Status in the World Community*, 5 N. CAROLINA. CENT. L. J. 326, 328 (1973-1974) ("colonial device"); Hadawi, *supra* note 28, at 19 ("a form of colonization").

[111] Mills, *supra* note 107, at 57.

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consent of the governed", and that "no right anywhere exists to hand peoples about from sovereignty to sovereignty as if they were property."[112]

In his address to a Joint Session of Congress in January 1918, President Wilson then announced his famous "Fourteen Points", which he deemed to be the "only possible program" for the "world's peace".[113] In six of the fourteen points, Wilson dealt with aspects of self-determination. In particular, regarding "colonial claims", he maintained that "the interests of the populations concerned must have equal weight with the equitable claims of the government".[114] As far as the non-Turkish parts of the Ottoman Empire were concerned, they were to enjoy "an absolutely unmolested opportunity of autonomous development".[115] Wilson described the principle underlying his "Fourteen Points" as "the principle of justice to all peoples and nationalities, and their right to live on equal terms of liberty and safety with one another, whether they be strong or weak".[116]

Despite this attitude towards colonized peoples seeming innovative, it is notable that self-determination, as envisaged in the "Fourteen Points", appears to be a more limited concept than in previous statements made by President Wilson. The seemingly hierarchical distinction made between "assuring sovereignty" -with regard to Belgium or Turkey-, "assuring autonomous development", as outlined in the case of non-Turkish parts of the Ottoman Empire, and the mode for settling "colonial claims" by giving "equal weight" to "the interests of the populations concerned" as far as other areas are concerned, is conspicuous.[117]

Soviet attitudes to self-determination should be mentioned briefly.[118] Lenin's *Decree on Peace* of 26th October 1917, was much more far-reaching than

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[112] President Wilson, "Civil War and Imperialism", Encyclopedia of the New American Nation; http://www.americanforeignrelations.com/O-W/Self-Determination-Civil-war-and-imperialism.html.
[113] "President Wilson's Fourteen Points", World War I Document Archive, 1-5; http://wwi.lib.byu.edu/index.php/President_Wilson%27s_Fourteen_Points; Quigley, *supra* note 7, at 16-17; Kattan, *supra* note 6, at 48-49; Gresh, *supra* note 10, at 64.
[114] Point V.
[115] Point XII.
[116] "President Wilson's Fourteen Points", World War I Document Archive, 4; *supra* note 113.
[117] Points VII and XII (Belgium and Turkey); *supra* note 115 (non-Turkish parts of the Ottoman Empire); *supra* note 114 (colonial claims); L.C. Green, *Self-Determination and Settlement of the Arab-Israeli Conflict*, 65 AM. SOC'Y INT'L L. PROC. 40, 41-42 (1971); Quigley, *supra* note 7, at 17.
[118] For more details, see: Quigley, *supra* note 7, at 15-16; Kattan, *supra* note 6, at 118-119; Anghie,

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Wilson's concept of self-determination.[119] Although at that time Soviet influence on international law's development was minimal, it seems likely that worries about the Bolshevist programme's attractiveness helped persuade European powers to be more receptive to Wilson's more limited version of self-determination.[120]

4.1.2. COVENANT OF THE LEAGUE OF NATIONS

With President Wilson, the only true supporter of the principle among the First World War victors, toning down his rhetoric on self-determination, it was inevitable that –given the complete lack of enthusiasm for the concept on the part of the victorious European powers- it would be watered down further and only applied selectively, once the peace agreement would be negotiated.[121] Indeed, the result was that the concept of self-determination would be applied only in Europe. Conveniently, in Europe, the principle of self-determination had the decisive advantage of seemingly justifying the dismemberment of the Central Powers that had lost the war.[122]

Non-European areas, formerly dominated by the Central Powers, on the other hand, were deemed to require "tutelage" of varying degrees on the part of the "advanced nations" which were, of course, generally synonymous with the victors.[123] Regarding allied or other colonial possessions, no adjustments regarding self-rule were deemed necessary.[124]

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supra note 21, at 139.

[119] *Decree on Peace*; delivered at the *Second All-Russia Congress of Soviets of Workers' and Soldiers' Deputies, 26th October 1917,* and published by *Izvestiya,* (Oct. 27, 1917) http://www.historyguide.org/europe/decree.html.

[120] Kattan, *supra* note 6, at 118-119; Anghie, *supra* note 21, at 139.

[121] Collins, *supra* note 4, at 140; he warns against "blithely accepting" Wilson's and the Allied statements on self-determination; Huntington Gilchrist, *V. Colonial Questions at the San Francisco Conference*, 39 AM. POL. SCI. REV. 982, 989 (1945); he points out that even in 1945 "certain imperial powers maintained that many colonial peoples preferred dependence"; Anghie, *supra* note 21, at 119-120, 139-140.

[122] Green, *supra* note 117, at 41; Gresh, *supra* note 10, at 36, 48-49.

[123] League of Nations Covenant art. 22 (2).

[124] Green, *supra* note 117, at 42; he points out that the United States made it plain that it "would never concede to the local inhabitants the right of deciding upon the proposed transfer" when the Danish West Indies became American. The Danish West Indies were sold to the United States by way of a treaty in 1916 (Convention between the United States and Denmark, Cession of the Danish West Indies, August 4, 1916, U.S.T. 629). The islands are now referred to as the U.S. Virgin Islands.

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4.1.2.1. ARTICLE 22

These considerations are reflected in the *Covenant of the League of Nations*, signed at the Paris Peace Conference on 28th June 1919. Its Article 22 contains the mandates system's "constitution". "On behalf of the League" the mandatory powers were to "exercise" their "tutelage" of "peoples not yet able to stand by themselves under the strenuous conditions of the modern world".[125] Based on the different "stages" of "development" the peoples concerned had reached, three categories of mandates were established.[126]

The "*A*-Mandates", as outlined in Article 22 (4) of the Covenant, were applicable to "certain communities" formerly under Ottoman rule. Their "existence as independent nations" was "provisionally" recognized. They were to receive only "advice and assistance" until they could "stand alone". The "*B*-Mandates", outlined in Article 22 (5) of the Covenant, were to apply especially to "peoples of Central Africa". They envisaged "administration" by the mandatory power. Finally, the "*C*-Mandates", outlined in Article 22 (6) of the Covenant, were applicable to South-West-Africa and "certain South Pacific Islands". These areas were to be "administered under the laws" of the mandatory powers as "integral part" of their "territory".

Article 22 of the Covenant further required the mandatory powers to file annual reports on the mandated territories, established the *Permanent Mandates Commission,* and set out the Council of the League's responsibility for drafting the mandate's precise terms in cases when the League of Nations had not yet agreed on them.[127]

4.1.2.2. SOVEREIGNTY

One of the most hotly debated issues surrounding the mandates system, which has remained controversial, is where sovereignty over the mandated territories was to reside.[128] The Covenant does not provide an explicit answer,[129] which has

[125] League of Nations Covenant art. 22 (1) and (2).
[126] *Id.* article 22 (3).
[127] *Id.* article 22 (7)-(9).
[128] Mills, *supra* note 107, at 54; Mills points out that, during the peace negotiations, U.S. Secretary of State Lansing repeatedly (and unsuccessfully) tried to bring to President Wilson's attention the

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led to a proliferation of theories on the topic,[130] further complicated by the different categories of mandate.

There were those who concluded that the old-fashioned concept of sovereignty was ill suited to the legal novelty of the mandates system. They maintained that the question was unanswerable or that sovereignty was "in abeyance".[131] Others argued that sovereignty lay with the mandatory power as evidenced, for example, by that power's control of the mandated territories' foreign relations.[132] Others, again, argued that the League of Nations retained sovereignty and the mandatory was simply acting on its behalf, as evidenced by the League's supervisory role.[133] Another school of thought adhered to the

fact that it was not clear where sovereignty would reside as far as the mandated territories were concerned; Lauterpacht, *supra* note 97, at 514; Leeper, *supra* note 107, at 1204; Arnold D. McNair, *Mandates*, 3 CAMBRIDGE L.J. 149, 158-159 (1928); T.J. LAWRENCE, THE PRINCIPLES OF INTERNATIONAL LAW 80-82 (7th ed. 1923); WILLIAM EDWARD HALL, A TREATISE ON INTERNATIONAL LAW 162-163 (8th ed. 1924); Quigley, *supra* note 7, at 66-75; Kattan, *supra* note 6, at 56-58; Anghie, *supra* note 21, at 125-127, 133, 147-156.

[129] The fact that the issue of where sovereignty resided was not regulated explicitly in the Covenant should, perhaps, not be surprising. Many contemporary scholars and international lawyers would not have been unduly perturbed by this. As Craven has explained, as early as in the nineteenth century any definition of the term "state" necessitated the explanation of a vast array of different arrangements: "sovereign" and "semi-sovereign" states, vassals, unions, protectorates, etc.. By the middle of the century, a minimum of eleven different categories of states was recognized. This situation became even more complicated at the turn of the century, as treaties with non-European states and tribes seemed to require further differentiation based on a gradation of sovereignty. While non-European states could not be denied sovereignty completely, without rendering the treaties European states had concluded with them invalid, it was inconceivable to attribute to those states the kind of sovereignty European states enjoyed. Only when such non-European states had "demonstrated their 'civilized' credentials" was the "badge of imperfect membership" in the international community of sovereign states removed. As Craven has therefore concluded, the mandates system thus merely gave this belief "institutional form", based as it was on the "tutelage" of the peoples in the mandates by the "advanced nations" until they "were able to stand by themselves"see (Matthew Craven, *Statehood, Self-Determination, and Recognition, in* INTERNATIONAL LAW 203, 210-214 (Malcolm D. Evans ed., 3rd ed. 2010).

[130] *See* Yehuda Z. Blum, *The Missing Reversioner: Reflections on the Status of Judea and Samaria*, 3 Isr. L. Rev. 279, 282 (1968); Lawrence, *supra* note 128, at 80-82 (he believed there should be a case-by-case evaluation of where sovereignty resides based on the texts of the Mandate); Hall, *supra* note 128, at 162-163 (he believed sovereignty over the mandates to be divided between the mandatory power and the League of Nations); Quigley, *supra* note 7, at 66-75; Anghie, *supra* note 21, at 147-156.

[131] Blum, *ibid*, 282; Leeper, *supra* note 107, at 1208 ("best solution"); International Status of South-West Africa, Advisory Opinion, 1950 I.C.J. Rep.128 (July 11) (separate Opinion by Sir Arnold McNair, J.).

[132] *See* Lord Balfour, Statement, 18th Session of the Council, 1922, 3 League of Nations O.J. (1922) 547.

[133] Bentwich, *supra* note 88, at 48; he seems to be inclined to agree with this view, when he states that the "League of Nations becomes the general guardian of three infant nations" who "delegates the care of the minor to a Power who is termed the Mandatory". In later articles, he seems more doubtful, especially regarding Palestine. He repeatedly points out that the "Mandatory exercises full power of legislation and administration"; Norman Bentwich, *Nationality in Mandated Territories Detached from Turkey*, 7 BRIT. Y.B. INT'L L. 97, 100 (1926).

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notion that sovereignty rested in the inhabitants of the mandated territories, albeit temporarily exercised by others.[134]

Many others argued that assuming shared sovereignty (in various combinations) was the correct solution, and some argued that the answer to the question where sovereignty rested was dependent on the category of mandate concerned.[135] The *International Court of Justice* (hereinafter I.C.J.), when later dealing with mandated territories, avoided taking an unequivocal stand on the issue.[136]

4.1.2.3. ASSESSMENT

Assuming sovereignty of the mandatory powers is incompatible with the Covenant of the League of Nations.[137] Although there is no doubt that the

[134] ICJ, Legal Consequence for States of the Continued Presence of South Africa in Namibia (South-West Africa) notwithstanding Security Council Resolution 276 (1970), Advisory Opinion, 1971 I.C.J. Rep. 16, 69 (June 21) (separate opinion by Vice-President Ammoun, J.); Judge Ammoun refers to Stoyanovsky's view "of virtual sovereignty residing in a people deprived of its exercise by domination or tutelage" as the "more accurate view"; Anghie, *supra* note 21, at 179-180; Corbett, *supra* note 109, at 129-130 (Corbett, however, limits this to "A" mandates).

[135] McNair, *supra* note 128, at 159-160; he, writing in 1927/1928, argues that sovereignty was divided between the League and the mandatory, the distribution dependent on the category of mandate. Later, when he was a Judge at the I.C.J., he seems to have changed his mind (I.C.J., International Status of South-West Africa, Advisory Opinion, 1950 I.C.J. Rep.128 (July 11) (separate Opinion by Sir Arnold McNair, J.); Corbett, *supra* note 109, at 129, 134 ("*A*"-Mandates: sovereignty inhabitants, some powers divided between Mandatory and League; "*B*" and "*C*" Mandates: sovereignty divided between Mandatory and League; Palestine as a special case); Charles Henry Alexander, *Israel in Fieri*, 4 INT'L L. Q. 423, 423-426 (1951); Alexander offers another explanation, which, however, fails to convince. He argues that sovereignty with regard to the mandated territories lay with the Principal Allied and Associated Powers. He bases that on Article 118 of the *Treaty of Versailles*. This theory is fraught with difficulties. The Allied Powers never claimed sovereignty regarding the mandated territories. Moreover, referring to the problem of the dissolution of the Supreme Council, which made the administration of any shared sovereignty impossible, he claims that this made no difference to the legal situation. Lastly, in order to justify his post-World War II conclusions, he implies that the "powerful nations" -and therefore presumably the states that shared sovereignty- changed with the times. This view seems extremely far-fetched; Leeper, *supra* note 107, at 1204-1205; he points out that only the United States ever claimed that sovereignty "resided in the Allied and Associated Powers"- a view that was so overwhelmingly rejected at the time that the United States dropped this position.

[136] *See* Legal Consequences for States of the Continued Presence of South Africa in Namibia (South-West Africa) notwithstanding Security Council Resolution 276 (1970), Advisory Opinion, 1971 I.C.J. Rep.16, 28-30 (June 21)- the I.C.J. explicitly rejected the notion that sovereignty resided in the mandatory powers. An implicit rejection by the I.C.J. of the idea that the League of Nations retained sovereignty over the mandated territories can be seen in the court's statement, after having rejected the notion that the League of Nations' function amounted to that of a "mandatory": "It [the League of Nations] had only assumed an international function of supervision and control." (in: International Status of South-West Africa, supra note 135, at 132) The I.C.J., however, avoided a conclusive statement on where it believed sovereignty actually did reside.

[137] *See* I.C.J., Legal Consequences for States of the Continued Presence of South Africa in Namibia (South-West Africa) notwithstanding Security Council Resolution 276, supra note 136 (the I.C.J.

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mandatory powers exercised many sovereign functions for the mandated territory, especially in the case of the "C"-Mandates, it is widely assumed that the mandatory power did not have a unilateral right of annexation or territorial adjustment.[138] Furthermore, some argue that the League of Nations, theoretically at least, was empowered to withdraw the Mandate in cases of persistent violations of the Mandate's terms on the part of the mandatory power.[139] This cannot easily be reconciled with assuming the mandatory power's sovereignty.

Further indications that sovereignty over mandated territories did not rest in the mandatory are: a) the obligation of the mandatory powers to provide annual reports to the League of Nation; b) the role of the *Permanent Mandates Commission* in supervising the mandatory power; c) the compulsory role of the *Permanent Court of International Justice* (hereinafter P.C.I.J.); d) the *League of Nations' Council's* -at least theoretical- role in drafting the mandates; e) and the fact that even inhabitants of the "*C*"-Mandates did not become nationals/subjects of the mandatory power.[140] Regarding "*A*"-Mandates -whose "existence as independent nations" was "provisionally recognized" and where the mandatory's role was reduced to "advice and assistance"- the notion that sovereignty resided in the mandatory becomes untenable.[141]

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rejected that notion even in the case of "C"-mandates); Lauterpacht, *supra* note 97, at 514; Lewis, *supra* note 97, at 469, 470; McNair, *supra* note 128, at 151; Quincy Wright, *Sovereignty of the Mandates*, 17 AM. J. INT'L L. 691, 695-696 (1923); Kattan, *supra* note 6, at 134-135.

[138] Corbett, *supra* note 109, at 134-135; Goudy, *supra* note 107, at 180; Quigley, *supra* note 7, at 66-68.

[139] *See* I.C.J., Legal Consequences for States of the Continued Presence of South Africa in Namibia (South-West Africa) notwithstanding Security Council Resolution 276, supra note 136, at 47-50; Goudy, *supra* note 107, at 180; Wright, *supra* note 137, at 702-703; Kattan, *supra* note 6, at 144-145; Corbett, *supra* note 109, at 135; he disagrees, and argues there was no right of "revocation" on the part of the League; McNair, *supra* note 128, at 157-158, fn. 7; he acknowledges that the issue is "controversial".

[140] *See* Norman Bentwich, *Palestine Nationality and the Mandate*, 21 J.COMP. LEGIS. & INT'L L., no. 4, 1939 at 230; when dealing with the issue of nationality, Bentwich argues that Palestine citizens were not British subjects, precisely because Palestine had "not been transferred" to Britain. He points out that Palestinians do not "owe allegiance to the Crown". This is confirmed by the fact that the issue of Palestine nationality was dealt with in an *Order in Council*, dated 24th July 1925, under the *Foreign Jurisdiction Act*; Bentwich, *supra* note 133, at 100; Leeper, *supra* note 107, at 1206; Lewis, *supra* note 97, at 469-470; Wright, *supra* note 137, 695; Quigley, *supra* note 7, at 66-68; Kattan, *supra* note 6, at 136; Anghie, *supra* note 21, at 151-153, 182-186 (he describes how intrusive the questionnaires were, which the *Permanent Mandates Commission* sent out to the mandatory powers annually).

[141] I.C.J., International Status of South-West Africa, Advisory Opinion, 1950 I.C.J. Rep 132 (11 July); Quigley, *supra* note 7, at 66-68.

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Discussions during the Paris Peace Conference confirm this. President Wilson, rejecting a French proposal that differed from the mandatory system, declared that the French proposal "implied definite sovereignty, exercised in the same spirit and under the same conditions as might be imposed upon a mandatory", while the mandatory system presumed "trusteeship on the part of the League of Nations".[142] Lloyd George described the mandates system as a "general trusteeship".[143] Accordingly, the I.C.J. has rejected the assumption that sovereignty was "transferred" to the mandatory even when "C"-Mandates are concerned. With the exception of South Africa, no mandatory power ever claimed sovereignty over the mandated territories.[144]

The League of Nations' role regarding the mandated territories was certainly significant.[145] However, it is questionable whether that role amounted to sovereignty over the mandated territories.[146] The mandatory powers were to provide their "tutelage" to the mandated territories "on behalf of the League", and the League was to perform considerable supervisory functions as already outlined. The *Permanent Mandates Commission* certainly took its supervisory tasks very seriously and adopted "the widest possible interpretation" of its rights. The I.C.J. has repeatedly stressed the importance of these supervisory functions.[147]

Nevertheless, given the following facts, it is difficult to sustain the argument that sovereignty over the mandated territories rested in the League: a) the fact that the mandates system's official goal was that all mandated territories should become independent states; b) the fact that the question of who should become mandatory power had already been decided by the Allies prior to the League taking up its functions; and c) the fact that the mandatory power only was to provide administrative assistance on the behalf of the

[142] President Wilson, U.S. Department of State, Papers relating to the Foreign Relations of the United States, The *Paris Peace Conference*, 1919, Volume 3, 765.
[143] Lloyd George, U.S. Department of State, Papers relating to the Foreign Relations of the United States, 770.
[144] Leeper, *supra* note 107, at 1207.
[145] Lauterpacht, *supra* note 97, at 514; Lewis, *supra* note 97, at 474.
[146] For the I.C.J.'s view, see *supra* note 136 and Legal Consequences for States of the Continued Presence of South Africa in Namibia (South-West Africa) notwithstanding Security Council Resolution 276, Advisory Opinion, 1971 I.C.J. Rep 29 (21 June); Leeper, *supra* note 107, at 1205; he points out that the League never claimed sovereignty; Wright, *supra* note 137, at 697.
[147] *See* I.C.J., International Status of South-West Africa, *supra* note 141, at 136.

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League, as far as the "A"-Mandates were concerned.[148] Moreover, this is confirmed by the discussions surrounding Iraq's future independence (the former Mandate for Mesopotamia/Iraq) in 1931: the question of a *transfer* of sovereignty from the League -for example, by way of a treaty- was never discussed.[149]

The correct view of the mandates system seems to be that sovereignty already rested in the nations under mandate, but it was exercised temporarily by the mandatory power under the League of Nations' supervision on behalf of these nations.

Early statements made by officials in the Foreign Office regarding Britain's aims confirm this. In December 1918, a future member of the delegation to the Peace Conference in Versailles described it as the "foundation" of British policy regarding Palestine that there should be "a Palestinian State with Palestinian citizenship for all inhabitants, whether Jewish or non-Jewish."[150] Accordingly, citizens of "A"-Mandates, including Palestine, not only had a nationality separate from that of the mandatory, but actually had their own nationality.[151]

Furthermore, once the mandates were in place, the mandatory powers and third states tended to treat the mandated territories as future states, even though the governmental functions were exercised by the mandatory. Among other things, the mandatory powers concluded treaties with third states for the mandated territories. The United Kingdom concluded a number of treaties on

[148] Lauterpacht, *supra* note 97, at 514-515; Wright, *supra* note 137, at 697; Quigley, *supra* note 7, at 66.

[149] The *Permanent Mandates Commission*, in September 1931, enumerated the general prerequisites regarding the termination of a mandate (which it examined in connection with Iraq's prospective independence). These principles were subsequently approved by the *Council of the League of Nations*; a transfer of sovereignty was not among the requirements; see Permanent Mandates Commission, League of Nations Doc. C.830M.411 1931 VI (1927).

[150] Arnold Toynbee (Political Intelligence Department of the British Foreign Office); Minutes of 2 December 1918; reprinted in Ingrams, *supra* note 1, at 43 (PRO. FO. 371/3398); furthermore, Treaty of Peace with Turkey (Treaty of Lausanne) art. 30, Jul. 24, 1923, 28 L.N.T.S 11 (concluded after the *Covenant of the League of Nations* had come into force) stated: "Turkish subjects habitually resident in territory which in accordance with the provisions of the present Treaty is detached from Turkey will become ipso facto, in the conditions laid down by local law, nationals of the State to which such territory is transferred."

[151] Quigley, *supra* note 7, at 54-58; Kattan, *supra* note 6, at 137.

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behalf of Palestine,[152] including, in 1922, a bilateral treaty between itself and the mandated territory.[153]

Third states took a similar view of the relationship between the mandatory power and the Mandate. In 1932, the British government sought to grant Palestine trade concessions, and enquired of states it already had concluded Conventions of Commerce with as to their response to such a move.[154] Spain disapproved and declared that, as far as Palestine was concerned, "the territory in question could in no way be considered as imperial territory, but solely as a foreign country . . . . From this point of view, it was in a situation with regard to the mandatory power analogous to other sovereign states."[155] In their responses the United States and Italy both insisted that Palestine was a "foreign country" in relation to the United Kingdom, and went on to point out that this, in their view, also applied to all the other territories under British mandate.[156]

These reactions are also in line with the *Permanent Mandates Commission's* view, expressed in 1937, that the "Palestinians formed a nation, and that Palestine was a state, though provisionally under guardianship."[157] The Chairman of the Commission, when responding to an Iraqi statement on unrest in Palestine, expressed his views even more clearly:

> For the Mandates Commission, Palestine had never ceased to constitute a separate entity. It was one of those territories which, under the terms of the Covenant, might be regarded as "provisionally independent". The country was administered under

[152] Quigley, *supra* note 7, at 53-54 (listing many examples, mainly of treaties concluded between Palestine and Egypt); *see also* John Quigley, "The Palestine Declaration to the International Criminal Court: The Statehood Issue" (2009) 1-11, 6 (he lists a number of bilateral and one international treaty Palestine acceded to), http://iccforum.com/media/background/gaza/2009-05-19_Quigley_Memo_on_Palestine_Declaration.pdf.
[153] Agreement between the Post Office of the United Kingdom of Great Britain and Northern Ireland and the Post Office of Palestine for the Exchange of Money Orders, UK-Palestine, Jan. 10-23, 1922, 13 L.N.T.S. 9; Quigley, *supra* note 7, at 54.
[154] Quigley, *supra* note 7, at 61-64.
[155] *The Ambassador in Spain (Laughlin) to the Secretary of State*, 28th October 1932; U.S. Department of State, F.R.U.S., Diplomatic Papers, 1932, The British Commonwealth, Europe, Near East and Africa, 36-37.
[156] *See The Secretary of State to the British Chargé (Osborne),* 27th August 1932; *The Chargé in Italy (Kirk) to the Secretary of State*, 22nd October 1932; U.S. Department of State, F.R.U.S., Diplomatic Papers, 1932, *ibid*, 32, 35-36.
[157] Permanent Mandates Commission, Minutes of the Thirty-Second (Extraordinary) Session, Tenth Meeting, League of Nations, Jul. 30-Aug. 18 (1937); *supra* note 66.

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> an A mandate by the United Kingdom, subject to certain conditions and particularly to the condition appearing in Article 5: "The Mandatory shall be responsible for seeing that no Palestine territory shall be . . . . in any way placed under the control of the Government of any foreign Power".
>
> The Chairman would not go so far as to say that the Iraqi Government was making a deliberate attempt to control Palestine; but a foreign Power was intervening in Palestine's internal affairs, and it was difficult to distinguish between intervention and control.
>
> Palestine, as the mandate clearly showed, was a subject under international law. While she could not conclude international conventions, the mandatory Power, until further notice, concluded them on her behalf, in virtue of Article 19 of the mandate. The mandate, in Article 7, obliged the Mandatory to enact a nationality law, which again showed that the Palestinians formed a nation, and that Palestine was a State, though provisionally under guardianship. It was, moreover, unnecessary to labour the point; there was no doubt whatever that Palestine was a separate political entity.[158]

This understanding of the mandates system only seems compatible with the notion that sovereignty already rested in the inhabitants of the mandated territory. However, their exercise of that sovereignty was suspended to a varying degree, according to the class of mandate, until such a time when the peoples concerned "were able to stand by themselves".[159] During this interim

[158] Permanent Mandates Commission, *supra* note 66.

[159] I.C.J., Legal Consequence for States of the Continued Presence of South Africa in Namibia (South-West Africa) notwithstanding Security Council Resolution 276 (1970), Advisory Opinion, 1971 I.C.J. Rep. 16, 69 (June 21) (separate opinion by Vice-President Ammoun); Gainsborough, *supra* note 43, at 14; very similar to this line of argument, as far as "*A*"-Mandates, and especially Syria and Mesopotamia, are concerned: Corbett, *supra* note 109, at 129-130. He argues that sovereignty was "vested" in Syria and Mesopotamia themselves, except for certain "powers" that were divided between the Mandatory and the League of Nations; Leeper, *supra* note 107, at 1206; he concurs as far as "*A*"-Mandates are concerned, but not as far as "*B*"- and "*C*"- Mandates are concerned; Grief, *supra* note 62, at 6; referring specifically to Palestine. However, he implausibly argues that sovereignty was vested only in the Jewish people; Wright, *supra* note 137, at 696; his position is somewhat unclear; after having rejected the notion that sovereignty resided in the "mandated communities", he goes on to state that "communities under '*A*' mandates doubtless approach very close to sovereignty"; Peter Mansfield, *A History of the Middle East*, 2d ed., London: Penguin Books Ltd. (2003), 183 (he refers to the "*A*"-Mandates as "five new states"); Lewis, *supra* note 97, at 464; he disagrees (he refers to the "*A*"-Mandates as "caricatures of independent states"); Alexander also disagrees (*supra* note 135, at 425). He bases his argument on the principles of the English concept of trusts. He, however, overlooks the fact that there is

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period, the mandatory power exercised the functions of sovereignty under the League of Nations' supervision.

As far as the "*A*"-Mandates according to Article 22 (4) of the Covenant are concerned any other interpretation is untenable. After all, these peoples were already explicitly "provisionally" recognized as "independent nations", and their wishes were to be the "principal consideration" when choosing the mandatory.[160] But even as far as the "*B*"- and "*C*"- Mandates are concerned, the fact that these peoples were only "entrusted" to the mandatory power until they were able to stand on their own, implies that sovereignty resided in them. Due to the fact that these peoples were viewed as not yet able to properly exercise their sovereignty, it must be assumed that, during the period of the mandate, sovereignty and the full exercise of its functions fell apart. This interpretation has the further advantage of providing an identical answer to the question of where sovereignty resided for all three types of mandate -a state of affairs, which would normally be a treaty drafter's goal when drafting one single article such as Article 22 of the Covenant.

The way Article 22 (4)-(6) of the Covenant were phrased, nevertheless, makes it obvious that -contrary to the rhetoric- only the "*A*"-Mandates were ever considered to be worthy of true independence in the foreseeable future.[161] There seems little room for doubt that nobody drafting or ratifying the *Covenant of the League of Nations* truly envisaged the "*C*"-Mandates ever being

widespread agreement that the mandates system was not based on the English concept of trusts, but only included elements of it. Since Italy, France, and Japan -all civil law countries- were among the victorious allies anything else would also be surprising (*see* also: ICJ, International Status of South-West Africa, Advisory Opinion, 1950 I.C.J. Rep. 128 (July 11); Goudy, *supra* note 107, at 177-182; Goudy persuasively argues that the mandates system was "derived from" Roman law -hence the name- and that there were "numerous differences between the English law on trusts and the mandates system; a point also made by Keith, *supra* note 97, at 75).

[160] Amos S. Hershey, *The Essentials of International Public Law and Organization*, 2d ed., New York: The Macmillan Company (1927), 187-191, especially at 189, fn. 34; Hershey views mandated territories of the "*A*"-Class as comparable to the "most liberal" kind of "protectorate" and believes their status to be similar to that of Cuba. As far as Cuba (at 168, fn. 33) is concerned, Hershey states that the United States-Cuba treaty of 1903-1904 imposes "legal limitations upon sovereignty", and that U.S.-Cuban relations are therefore best described as being those of a "Protectorate". It should be noted that Cuba was at that time already a member of the League of Nations (at 169, fn. 33 cont'd.). Nevertheless, according to Hershey, it is not a "fully sovereign state". His comparison allows the conclusion that Hershey believed the "*A*"-mandates to be states, although not yet "fully sovereign"; a view shared by Quigley, *supra* note 7, at 26-31, 70-79.

[161] Dajani, *supra* note 78, at 34; he argues that "*A*"-Mandates were recognized as already existing "nations", which "*B*"- and "*C*"-Mandates were not; Strawson, *supra* note 2, at 40-41.

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more than completely dependent territories.[162] Their inhabitants' sovereignty was most likely going to be "suspended" forever.

4.1.3. PRESIDENT WILSON'S CONCEPT OF SELF-DETERMINATION AND THE COVENANT

For the peoples subjugated to the mandates system self-determination proved to be a rather hollow promise. During the League's existence, only Iraq (formerly Mesopotamia) managed, in 1932, to become an independent state, albeit politically tied to the United Kingdom. The French attempted to grant Syria independence in 1936. However, the French parliament never ratified the relevant treaty so that Syria only became independent in 1946. Under considerable -war-time- pressure, the French agreed to grant Lebanon independence in 1941, although the process only was completed "in stages".

By devising a complicated novel legal system of governing "backward" territories, Europe had managed to cling on to the "Fertile Crescent".[163] Old European ideas about other nations had obviously triumphed in Paris.[164] Further evidence of this is provided by the way territories were placed into different categories of mandates.

Based on their "stages of development" there was no objective reason for granting the Arabs in what is now Saudi Arabia independence, while insisting on an "*A*"-Mandate for Mesopotamia, Palestine, Syria, and Lebanon.[165] There was no reason to place the Palestinian Arabs -who formed the vast majority of the population in Palestine and invariably were described as "backward" when praising Jewish colonizing efforts- in the "*A*"-Mandate category, while denying that category to the whole of Africa.

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[162] Strawson, *supra* note 2, at 40-41; Anghie, *supra* note 21, at 121.

[163] Philby, *supra* note 42, at 158; Strawson, *supra* note 2, at 40-41.

[164] *See* Dankwart A. Rustow, *Defense of the Near East*, 34 FOREIGN AFF. 271, 286 (1955); writing in 1955, he states: "The West must rid itself of the habit .of thinking of Near Eastern countries as wayward or compliant children rather than as free agents in international politics"; Strawson, *supra* note 2, at 40-41; Anghie, *supra* note 21, at 137-139; Mansfield, *supra* note 159, at 174.

[165] Hirst, *supra* note 42, at 160; Hirst makes the point that "the most backward parts of the Arab world" were to become independent states, while the more "mature and advanced were to come under 'direct or indirect' rule"; Mansfield, *supra* note 159, at 183-184, 188; he makes a similar point in respect of Yemen which became independent in 1918 - a country he describes as "remote" and "backward".

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These completely arbitrary categorizations only served to mask European strategic goals and racial prejudice. The mandates system reflected the racial hierarchy as seen in Europe at the time.[166] As Anghie has commented, the only difference was that nations and cultures were no longer officially divided into "civilized" and "uncivilized", but instead into "advanced" and "backward".[167] Lloyd George's contribution to the discussion on the mandates system during the Paris Peace Conference confirms this: he declared that the system for areas where "the population was civilized but not yet organized" had to be different from "cannibal colonies where people were eating each other."[168]

Differences in treatment of the same "race", notably the varied treatment of the Arabs, were due to strategic concerns.[169] Oil-rich and strategically situated Mesopotamia could not be granted independence before securely tied to Britain. Both Syria and Lebanon were always viewed as part of the French sphere of influence; the French were frequently intervening in the area under the guise of protecting the relatively high number of Christians in Lebanon. Palestine, of course, required "tutelage" due to the holy sites in Jerusalem, its strategic location and, last but not least, the Balfour Declaration.

The way Palestine was dealt with would -in the coming decades- provide clear evidence for the thesis that imperialism, not the rights of peoples had triumphed at Versailles: although far removed from any concept of self-determination, colonization of the territory by European, and therefore alien, white settlers was deemed compatible with the mandates system. Balfour

[166] Examples of such views are to be found in Lewis, *supra* note 97, at 459 ("a formula for dealing with the tribes of Africa who enjoyed not a different civilization, but no civilization"); see also David Hunter Miller, *The Origin of the Mandates System*, 6 FOREIGN AFF. 277, 277 (1927-1928) (". . . . it involved the principle that the control of uncivilized people ought to mean a trusteeship or wardship . . . . "). Miller (at 281) also quotes General Smuts, credited with having invented the mandates system, as saying that it was not meant to apply to the "barbarians of Africa"; Anghie, *supra* note 21, at 168-178, 189-190; Mansfield, *supra* note 159, at 174.

[167] Anghie, *supra* note 21, at 189; Gresh, *supra* note 10, at 64; he makes a similar point by arguing that European imperialism could no longer be justified on the basis of a "divine right" and was therefore now justified as "tutelage".

[168] Lloyd George, U.S. Department of State, Papers relating to the Foreign Relations of the United States, The *Paris Peace Conference*, 1919, Volume 3, 786; a similar view is reflected in Bentwich's article, *supra* note 88, at 48. In it, he refers to the mandated territories as "infant nations" requiring a "guardian" and compares the mandates system to a "tutor/ward" relationship. He also describes these territories' status as similar to that of "minors".

[169] Miller, *supra* note 166, at 281; Philby, *supra* note 42, at 158; Mansfield, *supra* note 159, at 174; he describes the European view of the Arabs at that time as them being a "subject race" rather than a "governing race".

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admitted as much in 1919: "In the case of Palestine we deliberately and rightly decline to accept the principle of self-determination." [170]

The mandates system therefore did not truly reflect the principle of self-determination, but instead reflected the compromises the Europeans deemed necessary in order to appease the Americans.[171] The novel idea of creating a supportive system that helped peoples towards independence, while acknowledging their sovereignty -albeit suspended- is in some ways easier to reconcile with old imperialist notions than with any modern concept of self-determination.[172]

Owen rightly concluded that, as far as non-European areas were concerned, the "conflicts between the claims of race and language, the desires of the populations concerned, and the requirements of strategy, economics and national politics produced results which were neither admirable, nor, as it turned out, even workable."[173] The United States, understandably distrustful as far as the Europeans' motives were concerned, therefore only extended recognition to those mandates it had explicitly agreed to.[174]

[170] Letter from British Foreign Secretary Balfour to the British Prime Minister Lloyd George of February 19th, 1919; reprinted in Ingrams, *supra* note 1, at 61-62 (PRO. FO. 371/4179); Strawson, *supra* note 2, at 40-41; Gresh, *supra* note 10, at 36, 48-49; he explains how the treatment of the actual inhabitants of Palestine was typical of imperialism. They and their culture were virtually invisible and therefore non-existent.

[171] Wright, *supra* note 137, at 691.

[172] Mansfield, *supra* note 159, at 174, 180 (he describes the mandate system as a "thinly disguised form of colonial administration"); Owen, *supra* note 15, at 550; he describes how President Wilson was at one time so frustrated during the discussions on the mandates system that he threatened to leave the peace conference. Nevertheless, some were happy to use almost poetic language in order to describe the virtues of the mandates system. Bentwich (*supra* note 88, at 56) states:
"It is the very basis of the new world order which is realised by the League of Nations, that the attention of the world is focused directly and systematically on the tutelary government of the younger and less advanced nations; . . . . not that international law will be enforced by new physical sanction, but that it will be based upon a firmer and more systematic moral foundation; . . . .".

[173] Owen, *supra* note 15, at 554.

[174] Keith, *supra* note 97, 72; the USA recognized the Palestine Mandate in the Anglo-American Convention on the Recognition of the Palestine Mandate (1924), UK Treaty Series 054/1925; Cmd. 2559.

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4.2. THE PALESTINE MANDATE IN DETAIL

4.2.1. FIRST DECISIONS

Palestine, as a former part of the Turkish Empire, was an "A"-Mandate. At their conference in San Remo in April 1920, the Allies decided that Great Britain should be the mandatory.[175]

How that was to be reconciled with Article 22 (4) Covenant of the League of Nations, which by then already had come into force,[176] and which stated that the "wishes of the communities must be a principle consideration in the selection of the Mandatory", remained a very controversial issue. Balfour always had opposed consulting the Palestinians, as he made clear in a memorandum to Lord Curzon: "Whatever deference should be paid to the views of those living there, the Powers, in their selection of a mandatory do not propose, as I understand the matter, to consult them."[177]

The Americans,[178] on the other hand, did try to determine what local feeling was. In March 1919, the Americans had proposed that a commission be sent to Syria (which at that time included Palestine) in order to investigate how best to administer the area in future. The French, however, refused to participate, and the British withdrew.[179] Realizing that the European powers had probably made secret deals regarding the area, the Americans, nevertheless, decided to send their own fact-finding mission, the "King-Crane-Commission" (hereinafter the Commission).[180] The Commission concluded that 60% of the petitions received were in favour of an American

[175] San Remo Resolution, 25/04/1920, para. (c), *supra* note 94; France was to be granted Syria; Britain was to be the mandatory power for Mesopotamia.
[176] 10th January 1920.
[177] British Foreign Secretary Balfour in a memorandum addressed to Lord Curzon, dated 11st August 1919; reprinted in Ingrams, *supra* note 1, at 73 (PRO. FO. 371/4183).
[178] As has already been pointed out, the Americans insisted on not being an "ally". They claimed to be an "Associate Power", also because the United States had never declared war on the Ottoman Empire.
[179] Ingrams, *supra* note 1, at 70; in a letter Balfour had sent to Herbert Samuel in early 1919, he had already expressed "great hopes that Palestine will be eliminated from the scope of any Commission"; reprinted in Ingrams, *supra* note 1, at 66 (PRO. FO. 800/215); Mansfield, *supra* note 159, at 180; Barr, *supra* note 21, at 81-84.
[180] Pappe, *supra* note 11, at 8-10; Kattan, *supra* note 6, at 49.

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mandate. No other power had received more than 15% support, and there was least support for a French mandate. [181]

The disregard shown towards this local feeling would come to haunt the British. During the next few decades, numerous British commissions were sent to Palestine in order to deal with the fragile situation there. They were invariably confronted by the Palestinian Arabs who rejected the legitimacy of the British mandate on the grounds that Article 22 (4) Covenant had been violated, when Britain was chosen as the mandatory power for Palestine.[182] However, it cannot be ignored that Britain *did* emerge as the local inhabitants' second choice during the Commission's investigations,[183] and that, by April 1920, the Americans had made it plain they would not be taking on the Mandate.

The fact that the Allies ignored the wishes of the local inhabitants that Syria remain unified,[184] and that no part of the area be placed under French "tutelage",[185] was an early indication of the Allies' attitude towards the newly created international legal order. Adherence to the new norms was going to be an opportunistic affair.

Furthermore, the Allies, in San Remo, agreed that the "mandatory" was going to be responsible for "putting into effect" the British declaration "in favour of the establishment in Palestine of a national home for the Jewish people". The safeguard clauses contained in the Balfour Declaration were to be respected.[186]

This, too, evidenced complete disregard for the local inhabitants' wishes as described in detail by the Commission in 1919:

> 5. We recommend, in the fifth place, serious modification of the extreme Zionist Program for Palestine of unlimited immigration of

[181] "Recommendations of the King-Crane-Commission", 28/08/1919, para. 6 (3), *supra* note 6; Barr, *supra* note 21, at 84-86.
[182] Dajani, *supra* note 78, at 35; Weiß, *supra* note 17, at 154; he also cites the Iraqi Foreign Secretary making a statement to this effect in 1947 (fn. 20).
[183] "Recommendations of the King-Crane-Commission", 28/08/1919, para. 6 (6), *supra* note 6.
[184] A unified Syria consisting of Syria, the Lebanon, and Palestine; "Recommendations of the King-Crane-Commission", 28/08/1919, para. 2, *supra* note 6.
[185] The Commission claimed that more than 60 % of the petitions had protested "strongly and directly" against the French taking on any role in the area; "Recommendations of the King-Crane-Commission", 28/08/1919, para. 6 (6), *supra* note 6.
[186] San Remo Resolution, 25/04/1920, para. (b), *supra* note 94.

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> Jews, looking finally to making Palestine distinctly a Jewish State . . . . (3) The Commission recognized also that definite encouragement had been given to the Zionists by the Allies in Mr. Balfour's often quoted statement, in its approval by other representatives of the Allies. If, however, the strict terms of the Balfour Statement are adhered to- favoring "the establishment in Palestine of a national home for the Jewish people, it being clearly understood that nothing shall be done which may prejudice the civil and religious rights of existing non-Jewish communities in Palestine"-it can hardly be doubted that the extreme Zionist Program must be greatly modified. For a "national home for the Jewish people" is not equivalent to making Palestine into a Jewish State; nor can the erection of such a Jewish State be accomplished without the gravest trespass upon the "civil and religious rights of existing non-Jewish communities in Palestine." . . . .
>
> In his address of July 4, 1918, President Wilson laid down the following principle as one of the four great "ends for which the associated peoples of the world were fighting": "The settlement of every question, whether of territory, of sovereignty, of economic arrangement or of political relationship upon the basis of the free acceptance of that settlement by the people immediately concerned, and not upon the basis of the material interest or advantage of any other nation or people which may desire a different settlement for the sake of its own exterior influence or mastery." If that principle is to rule, and so the wishes of Palestine's population are to be decisive as to what is to be done with Palestine, then it is to be remembered that the non-Jewish population of Palestine -nearly nine-tenths of the whole- are emphatically against the entire Zionist program. The tables show that there was no one thing upon which the population of Palestine was more agreed than upon this. . . .[187]

The Commission's report can be seen as a prescient prediction of Palestine's fate. Nevertheless, the Americans and the Allies suppressed it.[188] The original justification for this was that the report might deter Congress from ratifying

[187] "Recommendations of the King-Crane-Commission", 28/08/1919, para. 5 (emphases by author), *supra* note 6.
[188] Pappe, *supra* note 11, at 10; Wright, *supra* note 21, at 5; Kattan, *supra* note 6, at 49; Macmillan, *supra* note 12, at 434 (she claims that "nobody paid the slightest attention" to the commission's report).

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the Peace Treaty of Versailles. However, even though the Americans had rejected the treaty much earlier, it was not until 1922 that the Commission's findings were published.[189]

The Allies' conduct at San Remo concerning the wishes and aspirations of Palestine's inhabitants again exposed the hollowness of all the promises of self-determination.[190] Nevertheless, it also needs pointing out that many leading Arabs did not take the Palestinians' wishes very seriously either. Faisal, son of the Sharif of Mecca and later King of Iraq, repeatedly expressed his sympathy for Zionist aspirations in Palestine.[191] In the "Faisal-Weizmann-Agreement" of 3rd January 1919, it was agreed that*:* "In the establishment of the Constitution and Administration of Palestine all such measures shall be adopted as will afford the fullest guarantees for carrying into effect the British Government's Declaration of the 2nd of November, 1917."[192]

However, Faisal conditioned this agreement on achieving Arab independence as promised by the British. Of course, the implementation of parts of the Sykes-Picot-Agreement meant that this promise would not materialize to the extent envisaged by the Arab leaders, so the "Faisal-Weizmann-Agreement" never came into force.[193]

Faisal, however, also wrote a letter, dated 3rd March 1919, to Felix Frankfurter, President of the American Zionist Organisation, declaring that

> The Arabs, especially the educated among us, look with the deepest sympathy on the Zionist movement. Our deputation here in Paris is fully acquainted with the proposals submitted yesterday by the Zionist Organization to the Peace Conference, and we regard them as moderate and proper. We will do our best, in so far as we are

[189] Mansfield, *supra* note 159, at 181; Kattan, *supra* note 6, at 49; they both also mention strong British and French resistance to publication.
[190] McGeachy, *supra* note 6, at 241; he describes the "Jewish occupation of Palestine" as "a conquest against the will of the inhabitants - made possible and respectable by the military support of a Great Power".
[191] Samuel, *supra* note 10, at 143; Weizmann, *supra* note 10, at 335; Strawson, *supra* note 2, at 43; Barr, *supra* note 21, at 70; Macmillan, *supra* note 12, at 433.
[192] Faisal-Weizmann-Agreement, art. 3 (Jan. 3, 1919), http://www.mideastweb.org/feisweiz.htm.
[193] Macmillan, *supra* note 12, at 433; Fromkin, *supra* note 9, at 324-325.

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> concerned, to help them through: we will wish the Jews a most hearty welcome home.[194]

For Arab leaders, too, the advancement of their personal ambitions was much more important than trying to ascertain, let alone respect local feeling in Palestine.[195]

4.2.2. TURKEY

The legality of the decisions taken at San Remo, including those on Palestine, is further put into doubt by the fact that at the time there was no peace treaty with Turkey.[196]

The *Treaty of Sèvres*, concluded in 1920, dealt with Palestine in Articles 95 and 96. Article 95 specifically referred to the Mandate and the terms of the Balfour Declaration. Turkey, however, never ratified the treaty.[197] When peace finally was agreed in the *Treaty of Lausanne* in 1923,[198] Turkey's declaration was much vaguer.[199] In Article 16 it was agreed that

> Turkey hereby renounces all rights and title whatsoever over or respecting the territories situated outside the frontiers laid down in the present Treaty and the islands other than those over which her sovereignty is recognised by the said Treaty, the future of these territories and islands being settled or to be settled by the parties concerned.

The *Treaty of Lausanne* came into force on 6th August 1924, at a time when the Mandate already had been approved and was being implemented. Such a sequence of events can hardly be reconciled with the 1907 Hague Regulations,

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[194] Letter from Emir Faisal to Felix Frankfurter, 03/03/1919. For the text of the letter, see: <http://www.jewishvirtuallibrary.org/jsource/History/FeisalFrankfurterCorrespondence.html>; Frankfurter himself also quotes the letter (*supra* note 5, at 413-414).

[195] El-Alami, *supra* note 57, at 180; Shlaim, *supra* note 9, at 7-8.

[196] Keith, *supra* note 97, at 72; he describes the legal situation in the "A"-Mandates in 1922 as "anomalous" due to the lack of a peace treaty with Turkey; Lewis (in 1923), *supra* note 97, at 460; he states that "the position in respect of Palestine and Syria is somewhat anomalous . . . . Turkey has neither ceded them formally nor recognized their independence".

[197] *See The Treaty of Peace Between the Allied and Associated Powers and Turk*ey (Treaty of Sèvres), Aug. 10, 1920, 113 B.F.S.P. 652; for Articles 1-260, <http://wwi.lib.byu.edu/index.php/Section_I,_Articles_1_-_260>.

[198] *See The Treaty of Peace with Turkey* (Treaty of Lausanne) (24 July 1923) 28 LNTS 11; for full text <http://wwi.lib.byu.edu/index.php/Treaty_of_Lausanne>.

[199] Lauterpacht, *supra* note 97, 514.

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especially Article 43, as, formally, the British position in Palestine at that time was that of a military occupier of "hostile" territory and no more. The British government implicitly acknowledged this anomalous situation in its Report on the Mandate for the year 1924 in which it stated: "The ratification of the Treaty of Lausanne in August, 1924, finally regularised the international status of Palestine as a territory detached from Turkey and administered under a Mandate entrusted to His Majesty's Government."[200]

4.2.3. THE MANDATE'S PROVISIONS

The League of Nations approved the text of the Palestine Mandate on 24th July 1922 and it came into force on 29th September 1923. The United States explicitly recognized the Mandate and its contents in the American-British Palestine Mandate Convention of 3rd December 1924.[201]

Its main provisions were that the mandatory was to have "full powers of legislation and administration"[202] and be "entrusted" with Palestine's "foreign relations".[203]

However, many of the articles dealt with the creation of a Jewish homeland in Palestine. The Balfour Declaration was reaffirmed in the Preamble. Arguably, its scope was extended by the statement that: "recognition has . . . . been given to the historical connection of the Jewish people with Palestine and to the grounds for reconstituting their national home in that country."[204] That was language rejected by the British cabinet when the Balfour Declaration was being drawn up.[205]

The mandatory was to be responsible for creating the necessary conditions for a Jewish national home in Palestine;[206] Jewish immigration was

[200] *Report of His Britannic Majesty's Government on the Administration under Mandate of Palestine and Transjordan for the year 1924*, Section I; *supra* note 104.
[201] Mandate for Palestine, League of Nations Doc. C.529.M.314 1922 VI (1927); Anglo-American Convention on the Recognition of the Palestine Mandate, supra note 174.
[202] Mandate for Palestine, *supra* note 201, art. 1
[203] *Id.* art. 12.
[204] *Id.* Preamble.
[205] Allain, *supra* note 17, at 83; Strawson, *supra* note 2, at 46; Mallison, *supra* note 53, at 1033; he argues that the Mandate must nevertheless be interpreted in line with the Declaration; as does Weiß, *supra* note 17, at 152.
[206] *Id.* art. 2

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to be encouraged, also by enacting a suitable nationality law and allowing "close settlement";[207] Hebrew was to be one of the official languages,[208] and the Zionist organisation was recognized as the "Jewish Agency" the mandatory was to cooperate with.[209]

However, due to a late amendment proposed by the British, they were released from their obligation to help establish a Jewish national home in the territory of Palestine *east* of the Jordan.[210] This area was later to become the state of Trans-Jordan (now the Hashemite Kingdom of Jordan).

The Mandate was thus the moment when the content of the Balfour Declaration definitely had arrived in international law.[211] From now on, the British government officially could claim that any move by it in favour of establishing a Jewish national home in Palestine was not simply in accordance with international law, but actually an international legal obligation. The terms of that obligation arguably went beyond what the majority of the British cabinet had envisaged when it approved the Balfour Declaration. Nevertheless, the British had agreed to undertake the mission and achieved a considerable reduction in territory to which the Mandate's terms applied.

4.2.4. THE MANDATE'S LEGALITY

Many have argued that the Mandate was illegal. While some have argued that it contravened the principle of self-determination,[212] others argue that its terms simply cannot be reconciled with Article 22 (4) of the Covenant. Before analysing these claims, it should, however, be pointed out that neither the

[207] *Id.* art. 7 (nationality law), art. 6 (settlement); regarding Article 6, the Military Governor of Palestine (1917-1920), Ronald Storrs, later commented: "The thinking Arab regarded Article 6 as Englishmen would regard instructions from a German conqueror for the settlement and development of the Duchy of Cornwall, of our Downs, commons and golf-courses, not by Germans, but by Italians "returning" as Roman legionaries . . . ." (*supra* note 27, at 356).
[208] Mandate for Palestine, *supra* note 201, art. 22.
[209] *Id.* article 4.
[210] Mandate for Palestine, *supra* note 201, art. 25; Grief, *supra* note 62, at 6; he argues that this was a "false interpretation", invented by Churchill, that "sabotaged" the Mandate.
[211] Dunsky, *supra* note 25, 167; Frankfurter, *supra* note 5, 414; Allain, *supra* note 17, 78; El-Alami, *supra* note 57, 147; Strawson, *supra* note 2, 46.
[212] Keith, *supra* note 97, 78; Quincy Wright, "The Palestine Conflict in International Law" in *Major Middle Eastern Problems in International Law*, Majid Khadduri (ed.), Washington D. C.: American Enterprise Institute for Public Policy Research (1972), 13-36, 26.

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P.C.I.J,[213] nor the *Permanent Mandates Commission*,[214] or the United Nations ever questioned the Mandate's legality.[215]

4.2.4.1. SELF-DETERMINATION

As has already been pointed out, the concept of self-determination, certainly when applied to "backward peoples", was comparatively novel to European politicians at the end of the First World War. The *Covenant of the League of Nations* reflects this. The American President had to compromise in order to avoid friction with former allies. The subsequent American withdrawal from multilateral engagement made a bad situation worse, by encouraging the Europeans to continue as far as possible on their well-trodden path of acquiring ever more power and influence in vital regions.

Notwithstanding the development or not of self-determination as a political principle, however, there can be little doubt that, by 1923, it had not yet become a *right* recognized in international law.[216]

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[213] *See* Mavrommatis Palestine Concessions (Greece v. U.K.), 1924 P.C.I.J. (ser. B) No. 3 (Aug. 30); Mavrommatis Jerusalem Concessions (Greece v. U.K.), 1925 P.C.I.J. (ser. A) No. 5 (Mar. 26). Arguably, the Court implicitly confirmed the Mandate's legality by not questioning the British Palestine Administration's right to make the necessary decisions regarding the concessions at stake.

[214] The *Permanent Mandates Commission* declared (when dealing with a petition from the Palestinian Arab Congress that alleged the Mandate's terms were contrary to Article 22 Covenant of the League of Nations):
". . . . .(b) Secondly the petitioners protest against the terms of the Mandate itself, as established by the Council of the League of Nations on July 24th, 1922 . . . . . the Commission, considering its task is confined to supervising the execution of the Mandate in the terms prescribed by the Council, is of the opinion that it is not competent to discuss the matter."
Observations by the Permanent Mandates Commission on the Petition Discussed at its Fifth Session, 6 League of Nations O.J. (1925) 219; the *Permanent Mandates Commission's* stance was subsequently approved by the Council, *32nd Session of the Council*, 6 League of Nations O.J. (1925) 133.

[215] When the General Assembly of the United Nations attempted to find a solution to the problems in Palestine, Sub-Committee 2 of the *Ad hoc Committee on the Palestinian Question* suggested referring the question of the legality of the Palestine Mandate to the *International Court of Justice*. In a narrow vote, this proposition was rejected. For the report of Sub-Committee 2, see: "Ad hoc Committee on the Palestinian Question, Report of Sub-Committee 2", U.N. Doc. A/AC.14/32; *see* http://unispal.un.org/pdfs/AAC1432.pdf.

[216] I.C.J., Accordance with International Law of the Unilateral Declaration of Independence by the Provisional Institutions of Self-Government of Kosovo, Advisory Opinion, 2010 I.C.J. 403, ¶ 79, 82 (Jul. 22); the court pointed out that the right of self-determination had "evolved" only in the "second half of the twentieth century"; Bassiouni, *supra* note 25, at 32; he describes the 1914-1945 period as one of "unfulfilled declarations on 'self-determination'"; Dunsky, *supra* note 25, at 170; Dunsky views the principle as "not part of international law" in 1919/1920, and as "a purely political factor, not binding in nature"; Collins, *supra* note 4, at 140; he describes the concept of self-determination post-World War I as only "theoretically based" but "gaining acceptance"; Green, *supra* note 117, at 46; writing in 1971, he argues that even then there was no right of self-determination in international law; Murlakov, *supra* note 4, at 86 (no right of self-determination

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As the *International Commission of Jurists,* reporting on the Aaland Island issue, stated in 1920:

> Although the principle of self-determination of peoples plays an important role in modern political thought, especially since the Great War, it must be pointed out that there is no mention of it in the Covenant of the League of Nations. The recognition of this principle in a certain number of treaties cannot be considered as sufficient to put it upon the same footing as a positive rule of the Law of Nations.[217]

Although the jurists, in their subsequent examination of the principle, did allow for specific exceptions to this categorical statement,[218] the text of the Covenant proves that their conclusion was fundamentally correct. When contrasting President Wilson's statements on self-determination outlined above with the failure even to mention "self-determination" in the Covenant, it becomes obvious that the majority of states did not recognize this principle as a *legal* principle, let alone an obligation.[219] Consequently, the I.C.J., too, has described the *right* of self-determination as having "evolved" only "during the

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even in 1947); JAMES CRAWFORD, THE CREATION OF STATES IN INTERNATIONAL LAW 108, 428, 433 (2nd ed. 2006); he describes the developments in the inter-war period regarding self-determination as demonstrating "the political force of the principle . . . . Nonetheless there was little general development before 1945" (at 112); Strawson, *supra* note 2, at 88; Martti Koskenniemi, *National Self-Determination Today: Problems of Legal Theory and Practice*, 43 INT'L COMP. L.Q. 241, 257 (1994); Kattan, *supra* note 6, at 120-121, 140-141; Kattan, however, wants to make an exception for "A"-Mandates under Article 22 (4) of the Covenant. He argues that these "communities" were granted the right of self-determination by the Covenant. That argument is difficult to sustain. It was, after all, not up the "communities" to decide whether they had "progressed sufficiently" to be independent, but up to the mandatory power and the League of Nations. Article 22 (4) is perhaps best seen as holding out the promise to these "communities" that they will at some point in the future, to be determined by others, be able to claim a right to self-determination.

[217] Report of the International Committee of Jurists Entrusted by the Council of the League of Nations with the Task of Giving an Advisory Opinion upon the Legal Aspects of the Aaland Islands Question, League of Nations O.J., Special Suppl. 3, 5th October 1920.

[218] Report of the International Committee of Jurists Entrusted by the Council of the League of Nations with the Task of Giving an Advisory Opinion upon the Legal Aspects of the Aaland Islands Question, ibid, 5, 6; Koskenniemi, *supra* note 216, at 246-247.

[219] Green, *supra* note 117, at 42; Gainsborough, *supra* note 43, at 11; he cites Feinberg as offering a completely different explanation, whereby it remains unclear whether Palestine was ever included in the "A"-Mandates category; furthermore, 22 (4) only contained "permissive, not obligatory" rules as implied by the sentence "where their existence . . . .". This argument has no merit. It is self-evident that Palestine was an "*A*"-Mandate. The majority of writers at the time, Britain, and the League of Nations referred to it as such (certainly until 1939). The discussions of the wartime allies provide ample evidence that all the former Turkish territories that were not granted independence were to be "*A*"-Mandates. Interpreting the language in Article 22 (4) Covenant of the League of Nations as optional is also beyond any reasonable interpretation. The text simply provides no basis for Feinberg's arguments.

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second half of the twentieth century", something it describes as "one of the major developments of international law."[220]

The whole concept of the mandates system could not have been reconciled with the existence of a *right* to self-determination, as it was not up to the peoples in the mandated territories to decide when they could "stand alone", but up to the mandatory power and the League of Nations. For peoples "not yet able to stand on their own" self-determination was therefore limited to an aspiration for the future. [221] The conclusion therefore must be that the Mandate did not violate the Palestinians' *right* to self-determination because there was no such right in contemporary international law.[222]

4.2.4.2. ARTICLE 22 (4) COVENANT OF THE LEAGUE OF NATIONS

Many have advanced the argument that the terms of the Mandate, without doubt an "*A*"-Mandate, cannot be reconciled with Article 22 (4) of the Covenant.[223]

Besides not having been consulted by the Allies on the choice of mandatory (as already described above), the inhabitants of Palestine were subject to a system whereby the "full powers of legislation and administration" were exercised by Britain. Britain only was obliged to "encourage local autonomy so far as circumstances permit."[224] Articles 1 and 3 of the Mandate therefore clearly violated the provisions of Article 22 (4) of the

[220] ICJ, *supra* note 216.
[221] As Marc Weller, points out, the E.C. Arbitration Commission on Yugoslavia *even in 1991/1992* "found that in actual practice international law did not define the precise consequences of that right or its scope of application . . . .the commission . . . . defined the right to self-determination not as a people's right to independence but as a human right of minorities and groups".*See* Marc Weller, *The International Responses to the Dissolution of the Socialist Federal Republic of Yugoslavia,* 86 AM.J.INT'L.L. 569, 569-607, 592 (1992).
[222] Stone, *supra* note 28, at 17-18; Stone argues that it is irrelevant whether there was a right of self-determination in international law at that time or not, as Arab demands for self-determination were fulfilled by gaining independence in an area 100 times greater than Palestine. That argument, however, fails to take account of the rights of the Arabs actually living in Palestine, then 90% of the population, whose country, according to Stone was to be sacrificed to allow Jews to achieve self-determination there -after all, the Jewish population amounted to only 10% of the whole population in Palestine.
[223] Dajani, *supra* note 78, at 34.
[224] Mandate for Palestine, *supra* note 201, art. 3.

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Covenant, which only allowed for the "rendering of administrative advice and assistance" by the mandatory.[225]

That Palestine was to have little in common with a "provisionally recognized independent nation" is evidenced by the detailed and extensive description of the mandatory's powers and obligations: without any reference to the locals' wishes, the mandatory was to facilitate Jewish immigration, enact a nationality law, and secure the Holy sites.[226] Obviously, such a course of action would only be viable if British conduct went way beyond "rendering advice" – rather, British usurpation of all executive functions in Palestine would have to be considered a conditio sine qua non.

Article 22 (8) of the Covenant does not help reconcile the Mandate with Article 22 (4) of the Covenant either, as any decision of the Council on the "degree of authority . . . . exercised by the Mandatory" must, of course, itself be in accordance with the type of mandate concerned. The "degree of authority" conferred to the mandatory in Palestine could only be within the limits set out in 22 (4) of the Covenant, which evidently were not respected in the Mandate.

A comparison with the Iraq Mandate, approved by the League of Nations on 27th September 1924,[227] further illustrates the special treatment of Palestine.[228] The Iraq Mandate incorporated the Anglo-Iraqi "Treaty of Alliance", signed 10th October 1922,[229] and the "Protocol of April 30th, 1923, and the Agreements subsidiary to the Treaty with King Feisal".[230]

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[225] Bentwich, *supra* note 78, at 140; he acknowledges this fact and explains it as a result of the "Jewish National Home" policy; Quigley, *supra* note 7, at 48; Keay, *supra* note 9, at 193, 203-204; Gresh, *supra* note 10, at 69; Macmillan, *supra* note 12, at 436; she concludes: "In place of the duty of the mandatory power to develop a self-governing commonwealth, they [the British] substituted 'self-governing institutions.'"

[226] Mandate for Palestine, *supra* note 201; Stein, *supra* note 54, at 418; he, however, claims that the Mandate differed from the other "A"-mandates only in as far as the "trusteeship" was deemed "to be of indefinite duration".

[227] For the text of the Iraq Mandate, and its approval by the League of Nations, see: British Mandate for Iraq, League of Nations Doc. C. 412. M. 166. 1924 VI (1924).

[228] Bentwich, *supra* note 78, at 137 ("the mandate for Palestine has a distinctive character"); *supra* note 88, at 50 ("markedly different"); Keith "Mandates", 78 ("differentiate this from all other mandates"); Quigley, *supra* note 7, at 48-51; Keay, *supra* note 9, at 203-204.

[229] For the text of the Treaty between Great Britain and Iraq, G.B.-Iq., Dec. 1922, League of Nations O.J. C. 717 M. 429. 1922. VI.

[230] For the text of the "Protocol", see: Treaty between Great Britain and Iraq, G.B.-Iq., July 1923, League of Nations O.J. C. 373. M. 168. 1923. VI.

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In the "Treaty of Alliance" Britain recognized Feisal as the "constitutional King of Iraq".[231] "At the request" of Iraq's King, the British government promised to "provide the State of Iraq . . . . advice and assistance", however without prejudice to Iraq's "national sovereignty", however without prejudice to Iraq's "national sovereignty".[232] Furthermore, Iraq was permitted to have representations abroad,[233] and both parties agreed to submit any disagreements on the treaty's interpretation to the P.C.I.J. [234] The Iraq Mandate itself included the statement that Britain had recognized the Iraqi government as "independent",[235] and mentions the possibility of Iraq's future admission to the League of Nations.[236]

Although the "Treaty of Alliance" also contained provisions severely restricting Iraq's ability to act independently,[237] the language used is strikingly different from the language employed in the Palestine Mandate.[238] While it was easy to claim that the Iraq Mandate adhered to the letter and spirit of Article 22 (4) Covenant of the League of Nations, the same was not possible with respect to the Palestine Mandate, although both were "*A*"-Mandates.

The Mandate's terms' (and subsequently Britain's) lack of compliance with Article 22 (4) of the Covenant was acknowledged implicitly by the Secretary of State for the Colonies MacDonald before the *Permanent Mandates Commission* in 1939:

> Mr. MacDonald reiterated that the Palestine mandate was different from all the others; but it was, nevertheless, a mandate and had to embody the spirit and principles of the mandate system. It was not so different that its provisions could contradict those principles. If the Arabs of Palestine, alone among all the populations of territories under mandate, were to be deprived of normal political rights, it

[231] Preamble, *supra* note 229.
[232] Preamble, *supra* note 229, article I.
[233] Preamble, *supra* note 229, article V.
[234] Preamble, *supra* note 229, article XVII.
[235] British Mandate for Iraq, League of Nations, Doc.C. 412. M. 166. 1924 VI (1924).
[236] *Id.* article VI.
[237] The Iraqi King agreed to be "guided" in "all important matters" affecting British "financial and international interests" (*supra* note 229, art. IV), and no non-Iraqi was to be employed by the Iraqi government without prior "concurrence" on the part of the British government (Article II, *supra* note 229).
[238] Quigley, *supra* note 7, at 42-44; Keay, *supra* note 9, at 203-204.

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> would amount to saying that the Palestine mandate contradicted the spirit of the mandates system . . . .
>
> In reply to Mlle. Dannevig's remark about the premature introduction of self-governing institutions, he would remind the Commission that the Arabs and Jews in Palestine were fairly advanced peoples. It remained true, however, that, in twenty years, no progress whatever had been made with the establishment of even the most modest form of central self-government, apart from local government bodies. Palestine was, in fact, behind some other parts of the world where the people were actually more backward . . . .[239]

There is therefore little doubt that the Mandate *did* violate Article 22 (4) of the Covenant.[240] Although Palestine was an "*A*"-Mandate, its treatment at best was equivalent to "*B*"-Mandate status.[241] This "special treatment" of Palestine had been foreshadowed in the defunct *Treaty of Sèvres*. While "Syria" and "Mesopotamia" were to be "provisionally recognized as independent States",[242] there was no such provision for Palestine, which was simply to be administered in accordance with Article 22 of the Covenant.[243]

The fact that the mandates themselves generally are viewed as international treaties in their own right -a view supported by the I.C.J.-[244] does not justify the violation of international law.[245] According to Article 20 (1) of the Covenant, member states undertook the obligation not to enter into treaties "inconsistent" with the Covenant's provisions.[246] Whether the League of Nations' approval of the Mandate can be viewed as an implicit abrogation, either of Article 20 (1) or of Article 22 (4) of the Covenant, is rather doubtful. There is no evidence of that being a consideration at the time.

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[239] Malcolm MacDonald before the *Permanent Mandates Commission*, Minutes of the Thirty-Sixth Session, Held at Geneva from June 8th to 29th, 1939, including the Report of the Commission to the Council, Fourteenth meeting; <http://ismi.emory.edu/home/resources/primary-source-docs/1939minutes.pdf>.
[240] Allain, *supra* note 17, at 87.
[241] Corbett, *supra* note 109, at 131; he describes Palestine as "a regime peculiar to itself" that "for the purposes of legal definition" falls "within the same group as … countries under mandates "*B*" and "*C*"; Dajani, *supra* note 78, at 35.
[242] *Supra* note 197, art. 94; for Articles 1-260, *supra* note 197.
[243] *Id.* article 95.
[244] See South-West Africa Cases, Preliminary Objections, 1962 I.C.J. Rep. 319, 330-331; Quigley, *supra* note 7, at 37.
[245] Rosenne, *supra* note 55, at 48; Rosenne seems to disagree, without giving any reasons.
[246] The Covenant came into force on 10th January 1920. The Palestine Mandate was approved by the League of Nations on 24th July 1922 (and came into force on 29th September 1923).

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The more convincing conclusions are that the Mandate was -as Bentwich would have presumably put it-[247] "imperfect in its legal foundations", and that its terms violated Article 22 (4) of the Covenant, and therefore also Article 20 (1).[248]

Nevertheless, some have contended that this conclusion faces four "insuperable barriers":[249]

1.) The League of Nations' approval of the terms of the Mandate had "definitive legal effect so that no other body could question its legality."[250]

2) The P.C.I.J. and the *Permanent Mandates Commission* had never raised the issue of the Mandate's alleged unlawfulness, despite having the opportunity to do so.[251]

3) All members of the League and "interested parties" had treated the Mandate as legal,[252] and, lastly,

[247] Bentwich, *supra* note 88, at 52 (referring to the implementation of new immigration laws before the Palestine Mandate had been approved); Bentwich was Legal Secretary, then Attorney General in the Government of Palestine.

[248] This is to some extent also confirmed by discussions that took place within the American Delegation, which participated in the drafting of the U.N. Charter and was responsible for working out the American response to suggested amendments to the *Dumbarton Oaks Proposals*. The Trusteeship system that was to be introduced in the U.N. Charter was to maintain the status quo as far as the mandates were concerned. In this connection, the U.S. Delegation in the end decided to reject an Arab League proposal, which would have explicitly included Article 22 (4) of the Covenant in the articles dealing with the Trusteeship system. As the discussions demonstrate, this rejection was due almost exclusively to the situation in Palestine. Although all the delegates agreed that the United States was in favour of retaining the status quo there, inclusion of Article 22 (4) of the Covenant in the U.N. Charter would, it was feared, be strongly opposed by the Jewish representatives. As Representative Bloom pointed out the phrase "the wishes of these communities must be a principal consideration" might actually mean "the majority wishes" and that "the Arabs were in a substantial majority". According to Bloom, the Arabs wanted inclusion of Article 22 (4) in order to "obtain something for their own protection". He concluded his assessment with the warning that incorporation of Article 22 (4) "might be equally dangerous to other territories than Palestine". On the other hand the discussions included various references by different delegates to the importance of retaining the Palestine Mandate itself, and ensuring that the "maintenance of the status quo be mandatory". This seems to indicate that -certainly among the U.S. delegates- there was a feeling that, while the continued implementation of the Mandate would ensure the desired retention of the status quo, application of Article 22 (4) of the Covenant might endanger that goal; *Trusteeship*, U.S. Department of State, F.R.U.S., Diplomatic papers, 1945, General: the United Nations, 1945, 950-954.

[249] An additional argument is advanced by Grief, *supra* note 62, at 3; he argues that the rights contained in Article 22 Charter of the League of Nations only applied to the Jews, as far as Palestine is concerned. This is evidently not correct as all the ensuing discussions at the League of Nations and in the British Cabinet demonstrate. There was agreement that the problems in Palestine resulted from the fact that Palestinian Arabs -by having lived in the territory when the British arrived- could claim the rights under Article 22 of the Covenant and that this was difficult to reconcile with the promises made to the Zionist Jews.

[250] Crawford, *supra* note 216, at 429.

[251] Rosenne, *supra* note 55, 48; Crawford, *supra* note 216, 429.

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4) Article 80 (1) U.N. Charter had "legalized" all mandates retroactively.[253]

None of these arguments is convincing. The League of Nations' approval of the Mandate did not automatically legalize inherent violations of the Covenant. Since it is very doubtful that any League of Nations organ was legally competent to rule on the Mandate's adherence to the Covenant,[254] it follows that the Council's approval cannot have been a judgement on whether the Mandate's provisions actually were in accordance with the Covenant. Rather, the League's organs' lack of jurisdiction/competence to adjudicate on the Mandate's legality reinforces the point that there were severe doubts on the part of the Allies as to what the result of any such legal analysis would be.[255] Furthermore, as all mandates generally were seen as treaties, Article 20 (1) of the Covenant barred the United Kingdom from entering into a treaty that contravened Article 22 (4), whatever the Council decided, especially as there is no indication that the Council had the competence to overrule Covenant provisions.

However, it is true, as argued by some, that the P.C.I.J. and the *Permanent Mandates Commission* never questioned the Mandate's legality. Nevertheless, it does not automatically follow that the Mandate's content was legal. The P.C.I.J. was never asked to explicitly rule on the conformity of the

[252] Green, *supra* note 117, at 47; Wright, *supra* note 21, at 12; Crawford, *supra* note 216, at 429 ("general practice").
[253] Rosenne, *supra* note 55, at 49; Wright, *supra* note 21, at 12; Crawford, *supra* note 216, at 429.
[254] See Lord Balfour, Statement, 18th Session of the Council, 3 League of Nations O. J. (1922) 547 (referring to the Council); implicitly: M. Hyman, Report to the 8th Session of the Council, 1 League of Nations O.J. (1920) 339 (describing the Council's difficulty in determining appropriate terms for the Mandate and asking the Allies for "proposals"); also implicitly: *Letter to the Secretary of State of the United States of America, adopted by the Council on March 1st, 1921*, 2 League of Nations O.J. (1921) 142-143 (Responding to U.S. protests against the terms of a "C" mandate awarded to Japan, the Council refers to its limited freedom of action due to the fact that the Mandate had already been approved by it). The *Permanent Mandates Commission* declared (when dealing with a petition from the Palestinian Arab Congress that alleged the Mandate's terms were contrary to Article 22 Covenant of the League of Nations): ". . . . . (b) Secondly the petitioners protest against the terms of the Mandate itself, as established by the Council of the League of Nations on July 24th, 1922 . . . . . the Commission, considering its task is confined to supervising the execution of the Mandate in the terms prescribed by the Council, is of the opinion that it is not competent to discuss the matter"; *Observations by the Permanent Mandates Commission on the Petition Discussed at its Fifth Session*, 6 League of Nations O.J. (1925) 219; Keith, *supra* note 97, at 81; he, writing in 1922, argues that the P.C.I.J. had no jurisdiction to decide whether the Mandate conformed to Article 22
[255] Keith, *supra* note 97, at 75; he points out that even a mandate approved by the Council could nonetheless contravene Article 22 Covenant of the League of Nations.

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Mandate with Articles 20 (1), 22 (4) of the Covenant.[256] The *Permanent Mandates Commission* declared an Arab request to debate the Mandate's conformity with Article 22 of the Covenant inadmissible due to its own lack of competence.[257] If it were correct that no League of Nations organ had the competence to examine the Mandate's legality after approval by the Council,[258] the omission to do so on the part of the Court and the Commission is not only explained easily, but also devoid of legal consequence.

Another argument sometimes put forward is that, by acquiescing in the Mandate's terms and their application, the League of Nations' member states and the "interested parties" may have created customary international law with regard to Palestine.[259]

Although there is arguably some state practice in support of that proposition,[260] no corresponding opinio juris can be discerned, because no state ever claimed that Palestine was subject to any rules of international law that went *beyond* the Covenant's provisions. On the rare occasions the legality of the Mandate was debated officially, its conformity with Article 22 of the Covenant was stressed.[261] Britain, too, always insisted that this was the case.[262] Furthermore, before 1939,[263] no state and no League of Nations' organ officially

[256] Mavrommatis Palestine Concessions (Greece v. U.K.), 1924 P.C.I.J. (ser. B) No. 3 (Aug. 30); Mavrommatis Jerusalem Concessions (Greece v. U.K.), 1925 P.C.I.J. (ser. A) No. 5 (Mar. 26), *supra* note 213; Keith, *supra* note 97, at 81; Keith, however, argues that the P.C.I.J. had no competence to decide whether the Mandate conformed to Article 22.

[257] *See supra* note 214.

[258] *See supra* note 254.

[259] Green, *supra* note 117, at 47.

[260] On at least two occasions Balfour explained the British policy of refusing to "accept the principle of self-determination", as far as Palestine was concerned, by claiming that the situation in Palestine was "absolutely exceptional" or "unique"; Letter from Balfour to British Prime Minister Lloyd George; 19th February 1919; and Minutes of a conversation between Balfour and Justice Brandeis (leader of the American Zionists) in mid-1919; both reprinted in Ingrams, *supra* note 1, at 61-62, 71-73 (PRO. FO. 371/4179; PRO. FO. 800/217).

[261] The League of Nations Council, for example, when dealing with the mandated territories, including Palestine, declared in 1924: "Expresses itself…satisfied that the mandated territories…are in general administered in accordance with the spirit and letter of Article 22 and the terms of the mandates"; 32nd Session of the Council, League of Nations Doc. C.386M.132 1925 VI (1927); for the requirement of opinio juris in the creation of customary international law, see: North Sea Continental Shelf Case (Federal Republic Of Germany v Denmark and v Netherlands), 1969 I.C.J. Rep. 3, ¶73-74 (Feb 20).

[262] Officially, Balfour declared that the terms of the Palestine Mandate were "in conformity with the spirit" and "in compliance with" Article 22 of the Covenant; *The Chief of the British Delegation, Council of the League of Nations (Balfour), to the Secretary General of the League of Nations (Drummond)*, December 6th, 1920; available at: U.S. Department of State, F.R.U.S., 1921, 105.

[263] In 1939, the Chairman of the *Permanent Mandates Commission* asked the Secretary of State for the Colonies MacDonald whether he viewed Palestine as falling under Article 22 (4) of the

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ever doubted that Palestine was an "*A*"-Mandate, to which Article 22 (4) applied automatically.[264]

Based on these facts, it follows that no rules of customary international law were created in order to deal with the specific case of Palestine. By avoiding the issue of legality as far as possible, and, when that was not possible, by stressing the Mandate's adherence to Article 22 (4) of the Covenant, states and the League of Nations actively prevented the development of divergent customary international law as far as Palestine was concerned.

Article 80 (1) U.N. Charter could and did not obviate any legal shortcomings the mandates had. Firstly, Article 80 (1) U.N. Charter, even if it had attempted to legalize any previous violations of the *Covenant of the League of Nations*, could not have had any bearing on the assessment of the legal situation prior to that provision coming into force. Secondly, there are doubts as to whether Article 80 (1) really sought to change the legal situation. Rather, most agree that this provision was meant to preserve the status quo. This is obviously at odds with the argument that the article retroactively legalized a previously unlawful situation because that would necessarily imply an automatic change in the status quo.[265] The explicit preservation of the "rights . . . . of any peoples" in Article 80, which would seem to include the preservation of the right not to accept an illegal situation, is a further bar to the contrary interpretation.[266]

Covenant: "It should, however, be remembered that the question whether paragraph 4 of Article 22 of the Covenant could be considered as applying to Palestine was one which had on occasion been disputed, and had given rise to differences of opinion." MacDonald replied: "Without enlarging on the point or making enquiries of lawyers who might possibly disagree, he felt it was a matter which was open to some doubt."; *Permanent Mandates Commission*, Minutes of the Thirty-Sixth Session, Held at Geneva from June 8th to 29th, 1939, including the Report of the Commission to the Council, Fourteenth meeting; *supra* note 239.

[264] In 1937, the Chairman of the *Permanent Mandates Commission* Orts declared: "For the Mandates Commission, Palestine had never ceased to constitute a separate entity. It was one of those territories which, under the Covenant, might be regarded as "provisionally independent."; League of Nations, *Permanent Mandates Commission*, Minutes of the Thirty-Second (Extraordinary) Session, Devoted to Palestine, Held at Geneva from July 30th-August 18th, 1937, Tenth Meeting, *supra* note 66. This statement can only be reconciled with the view that Palestine was an "*A*"-Mandate under Article 22 (4) of the Covenant.

[265] Gilchrist, *supra* note 121, at 991; Gilchrist argues that Article 80 U.N. Charter was included because of the "fears of mandatory powers" that they might lose their "legal position in the mandated territories"; Quigley, *supra* note 7, at 88.

[266] Quigley, *supra* note 7, at 88; The inclusion of the term "peoples" in U.N. Charter art. 80 has, however, been interpreted as specifically referring to Jewish rights in Palestine (for example, Wright, *supra* note 21, at 13). This argument is not convincing. All the communities living in mandated territories, especially also of the "*B*" and "*C*" categories, did not yet fulfil the criteria of

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The conclusion therefore must be that the Mandate's terms were contrary to international law at the time of their approval and remained so until the mandate's termination.[267]

In truth, the Mandate was an expression of "double" hypocrisy: Palestine's inhabitants were not only refused self-determination, but the rules set up by the Allies in order to keep self-determination in check were also flouted, because they were still too generous to allow the implementation of the Balfour Declaration.[268] Of course, this was the case because any indigenous administration in Palestine was extremely unlikely to cooperate with the European idea of settling Jews in Palestine, and creating a national home for them there.[269] Therefore, British administrators had to be in place in order to enforce a concept the population was hostile to.

However, this does not automatically lead to the further conclusion that the entire Mandate was invalid. The fact that Palestine was a mandated territory remained and was in accordance with contemporary international law as reflected in the Covenant.

4.2.4.3. OTHER VIOLATIONS OF INTERNATIONAL LAW

Although the Allies had not bothered to consult the inhabitants of Palestine, the fact that the United States refused the Mandate, means that it was in

statehood, but, nevertheless, had rights under the respective mandate that were preserved under Article 80. There is therefore no reason to assume that Article 80 was adopted solely to protect Jewish rights in Palestine.

[267] Even Bentwich, at the time of writing Attorney-General of the Government of Palestine, admits that there is "scarcely any clause of the Palestine Mandate which is without its legal and practical problems" (*supra* note 78, at 141); Pitman B. Potter, *The Palestine Problem Before the United Nations*, 42 AM. J.INT'L .L. 859, 860 (1948); Potter goes even further, when he states: "The Arabs deny the binding force of the Mandate…and again they are probably quite correct juridically".

[268] Kattan, *supra* note 6, at 4-5; Gresh, *supra* note 10, at 69.

[269]Bentwich, *supra* note 78, at 139; he states that the "policy of the Jewish National Home" had "determined the particular character of the mandate for Palestine" and compares the mandate to British policy in Trans-Jordan in order to emphasize this point; in his article "Mandated Territories" (*supra* note 88, at 51) he reiterates that point: "the task of the Mandatory of Palestine is very much more difficult . . . . It was clearly necessary . . . . that the Mandatory should be able to exercise the powers inherent in the government of a sovereign state and should not have its functions limited to rendering of administrative advice and assistance."; Keith, *supra* note 97, at 77- 78; he compares the Palestine to the Iraq Mandate -where he sees Britain's role "reduced to the modest role contemplated in Article 22". He then argues that "in Palestine, on the other hand, the mandatory has and must retain sovereign power . . . . ", and goes on to explain the difficulties Britain will have when trying to create a Jewish national home there; Stein, *supra* note 54, at 417 ("sui generis"); Salt, *supra* note 6, at 127; Quigley, *supra* note 7, at 48-49.

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accordance with Article 22 (4) Covenant of the League of Nations that Britain, the inhabitants' second choice according to the *King-Crane-Commission*, was installed as mandatory power (even if that was mere coincidence).

Obliging Palestine to accept foreign, Jewish immigrants per se cannot be classified as contrary to international law as it then was.[270] As already pointed out, the right of self-determination, which nowadays very likely would be seen to be violated by such an obligation, was not yet developed in international law. It is sometimes argued that the concept of a Jewish national home as such violated Article 22 (1) of the Covenant, because it could not be reconciled with the "principle that the well-being of such peoples form a sacred trust of civilization", as far as the Palestinian Arabs are concerned.[271] There is little doubt that the implementation, in practice, of the concept of a Jewish national home amounted to a clear violation of Article 22 (1) of the Covenant. Nevertheless, it does not seem justified to categorize the mere obligation to accept foreign immigrants -even if they were granted citizenship rights- as necessarily harmful to the indigenous population and therefore automatically illegal, especially when the safeguard clauses included in the Mandate are considered.

Based on the paternalistic, imperialist attitude evidenced by the whole mandates system, it could be argued plausibly -as indeed it was- that the Arabs would benefit from Jewish innovation and expertise, a sort of Imperial tutelage in proxy. As outrageous as such an attitude seems today, it cannot be denied that it provided the basic justification for the whole mandates system and was therefore reflected in the *Covenant of the League of Nations* and international law in general.

Furthermore, the fact that this obligation -for practical reasons- necessitated a violation of Article 22 (4) of the Covenant by requiring the imposition of a British administration on Palestine does not render the obligation itself illegal. Although hardly enforceable, it would have -at the time- been possible to legally impose such an obligation on an indigenous

[270] Kattan, *supra* note 6, at 121; he believes this to be generally true, but not for areas classified as "*A*"-Mandates because he believes those "communities" had been granted the right of self-determination. As has been explained earlier, that view is not convincing.
[271] Crawford, *supra* note 216, at 429.

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administration (receiving British "advice"), without Article 22 (4) of the Covenant being violated.[272]

As had already been foreshadowed by the *Churchill White Paper* [273] and the Mandate, the Palestinian area *east* of the river Jordan was no longer part of this development. The Mandate -with few exceptions- allowed the British to decide which of the Mandate's provisions they wished to implement there.[274]

Shortly after the Mandate had been approved, the British government issued "*The Palestine Order in Council*".[275] In its Preamble, the *Order in Council* reiterated the obligation to fulfil the Balfour Declaration, but its Article 86 categorically stated that

> This Order In Council Shall Not Apply To Such Parts Of The Territory Comprised In Palestine To The East Of The Jordan And The Dead Sea As Shall Be Defined By Order Of The High Commissioner. Subject To The Provisions Of Article 25 Of The Mandate, The High Commissioner May Make Such Provision For The Administration Of Any Territories So Defined As Aforesaid As With The Approval Of The Secretary Of State May be prescribed.

Thus, the foundations of the "first partition" of Palestine had been laid.[276] "Eastern" Palestine, under its ruler, Emir Abdullah, another son of the Sharif of Mecca's and a British ally, was to become independent as the Kingdom of Trans-Jordan in 1946. Already in April 1923, however, Britain recognized Emir Abdullah as the ruler of Trans-Jordan, pending the establishment of a constitutional order there and the conclusion of a treaty between Britain and Trans-Jordan.[277] That Treaty was concluded on 15th May 1923, and therein

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[272] As already pointed out in the case of Iraq, the other mandated territories, which were much further advanced on the road to independence than Palestine, were also subject to various restrictions; Kattan, *supra* note 6, 121; Kattan believes the argument made here to be generally correct, but not applicable to areas classified as "A"-Mandates because, he argues, those "communities" had been granted the right of self-determination. As has been explained earlier, that view is not convincing.

[273] Winston Churchill, *"The British White Paper", supra* note 49.

[274] Mandate for Palestine, *supra* note 201, art. 25; Kattan, *supra* note 6, at 53.

[275] *The Palestine Order in Council*, 10th August 1922: <http://content.ecf.org.il/files/M00929_PalestineOrderInCouncil1922English.pdf>.

[276] This is confirmed by the Order in Council dealing with Palestinian citizenship (*Order in Council of His Majesty*, 24th July 1925). Palestinian citizenship was not to be granted to residents of Palestinian areas east of the Jordan; they became "nationals of Trans-Jordan"; Bentwich, *supra* note 133, at 106; Kattan, *supra* note 6, at 53.

[277] *Report of His Britannic Majesty's Government on the Administration under Mandate of Palestine and Transjordan for the year 1924*, Section II, para. 2; *supra* note 104.

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Britain recognized Trans-Jordan as a state, albeit in need of further British support on its road to independence.

Although Trans-Jordan was technically still included in the Mandate, it in reality was becoming a completely separate entity. Trans-Jordan's administration was much closer to Iraq's, and thereby conformed much more to Article 22 (4) of the Covenant than the events in western Palestine, now Palestine.[278] While the Mandate itself can hardly be reconciled with Article 22 (4) of the Covenant, its *implementation* in eastern Palestine, in the Emirate of Transjordan, nevertheless, was in accordance with the Covenant, which, as explained, is much more than can be said for (western) Palestine.

5. CONCLUSION

The British rule in Palestine was at no point consistent with international law. As has been shown, its occupation regime exceeded the legal limitations imposed on occupiers of enemy territory as laid down in the 1907 Hague Regulations. There can also be little doubt that the Palestine Mandate was not consistent with international law. As explained, it did not violate the Palestinian Arab's right to self-determination, as that concept had not yet developed into a legal right in international law, nor did it violate Article 22 (1) of the Covenant. However, the way Palestine was to be administered and the omission of any verifiable road map on the way to independence represented clear violations of Articles 20 (1), 22 (4) of the Covenant.[279]

This view was widely shared in Britain at the time. Shortly after the White Paper had been published, the British government suffered a reverse in the House of Lords. On 21st June 1922, the House of Lords passed the following motion:

[278] This, according to Stein, despite "Eastern Palestine" being "smaller", "more backward" , and only being able to "keep its head above water" with the help of British subsidies (*supra* note 54, at 415-416); Mansfield, *supra* note 159, at 208; he describes Trans-Jordan as "poor, undeveloped and thinly populated"; Barr, *supra* note 21, at 359; referring to Jordan being granted independence in 1946, Barr states: "The servile nature of Jordan's relationship with Britain was not a well-kept secret. Neither the United States nor the Soviet Union . . . . would initially recognise Jordan as an independent state."; Quigley, *supra* note 7, at 46-48.
[279] Kattan, *supra* note 6, at 55-56.

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> That the Mandate for Palestine in its present form is inacceptable to this House, because it directly violates the pledges made by His Majesty's Government to the people of Palestine in the Declaration of October, 1915, and again in the Declaration of November, 1918, and is, as at present framed, opposed to the sentiments and wishes of the great majority of the people of Palestine; that, therefore, its acceptance by the Council of the League of Nations should be postponed until such modifications have therein been effected as will comply with pledges given by His Majesty's Government. [280]

In the debate Lord Islington, the motion's proposer, described the Mandate as a "distortion of the mandatory system".[281] His motion was passed by a large majority.[282]

Even the British Foreign Secretary Balfour himself concurred:

> The contradiction between the letters of the Covenant and the policy of the Allies is even more flagrant in the case of 'independent' Palestine than in that of 'independent' Syria . . . . What I have never been able to understand is how it can be harmonised with the declaration, the Covenant, or the instructions to the Commission of Enquiry . . . . In short, so far as Palestine is concerned, the Powers have made no statement of fact which is not admittedly wrong, and no declaration of policy which, at least in the letter, they have not always intended to violate.[283]

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[280] Hansard,*supra* note 44; for further details: *Palestine Mandate defeated in Lords*, N.Y. TIMES, June 22, 1922, at 4; Collins, *supra* note 4, 157; Ingrams, *supra* note 1, at 169 (PRO. CO. 733/22).

[281] Hansard, Palestine Mandate, H.L. Deb. 21st June 1922 vol 50 cc994-1033, c1000; *supra* note 44; "Palestine Mandate defeated in Lords", *The New York Times.*

[282] Lord Islington declared: "The first point I desire to make in relation to my Motion is that those provisions embodied in the Palestine Mandate are in direct conflict with the fundamental principles of the mandatory system. In order to make good that point I must ask your Lordships to listen to me while I read two governing Articles in the Covenant of the League of Nations which represent what I call the fundamental principles of the mandatory system. They are in Article 22, which states that 'To those colonies and territories which, as a consequence of the late war, have ceased to be under the sovereignty of the States which formerly governed them [...] . there should be applied the principle that the well-being and development of such peoples form a sacred trust of civilisation.' Paragraph 4 of Article 22 goes on to say: 'Certain communities formerly belonging to the Turkish Empire have reached a stage of development where their existence as independent nations can be provisionally recognised, subject to the rendering of administrative advice and assistance by a Mandatory until such time as they are able to stand alone. The wishes of these communities must be a principal consideration in the selection of the Mandatory.' The establishment of a Zionist Home under the Palestine Mandate, as applied to the Articles that I have explained, is directly inconsistent with the undertakings embodied in those two Articles." Hansard, Palestine Mandate, H.L. Deb. 21st June 1922 vol 50 cc994-1033, c997; *supra* note 44.

[283] British Foreign Secretary Arthur Balfour in a Memorandum (11st August 1919) to Earl Curzon; extracts reprinted in Ingrams, *supra* note 1, at 73 (PRO. FO. 371/4183).

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Of course, notwithstanding these sentiments, Balfour officially declared that the terms of the Mandate were "in conformity with the spirit" and "in compliance with" Article 22 of the Covenant.[284]

Nevertheless, in the end, the British failed to benefit from this disregard of international law. From the first until the last day of their reign in Palestine, they were confronted by unrest. This would lead to numerous commissions being sent out to Palestine,[285] which came to contradictory conclusions of often dubious legality.[286] Finally, Britain could only admit defeat. In 1947, Palestine was referred to the United Nations with Britain refusing to make any recommendations on its future status.[287] In a speech to the House of Commons, British Foreign Secretary Bevin outlined the situation as follows:

> His Majesty's Government have . . . . thus been faced with an irreconcilable conflict of principles. There are in Palestine about 1,200,000 Arabs and 600,000 Jews. For the Jews, the essential point of principle is the creation of a sovereign Jewish State. For the Arabs,

[284] The Chief of the British Delegation, Council of the League of Nations (Balfour), to the Secretary General of the League of Nations (Drummond), 6 December 1920; available at: U.S. Department of State, F.R.U.S., Papers relating to the foreign relations of the United States, 1921, Volume I, 105.

[285] *See*, for example, the following selection: The Peel Commission (1937), *Palestine Royal Commission Report*, July 1937, Cmd. 5479 (often referred to as the *Peel Commission Report*, because Earl Peel had been the commission's chairman); *Palestine, Statement of Policy by His Majesty's Government in the United Kingdom*, July 1937, Cmd. 5513. For the full text, *see also* <http://ufdc.ufl.edu/UF00023167/00001>; *Policy on Palestine, Despatch dated 23rd December 1937, from the Secretary of State for the Colonies to the High Commissioner for Palestine*; for the full text, see: <https://unispal.un.org/DPA/DPR/unispal.nsf/0/BBBC9DD3AED1E0E2852570D20077E7DE>; The Woodhead Commission (1938), *see*: *Palestine Partition Commission*, Report, Cmd. 5854; The *MacDonald White Paper* (May 1939). For the full text of the White Paper (*Palestine, Statement of Policy, Cmd. 6019*), see: 20 League of Nations O.J. (1939) 363-369; also reprinted *Palestine, Text of the White Paper*, TIMES, May 18th ,1939, at 9.

[286] Due to the Jew's minority status in Palestine, the Peel Commission, for example, concluded that the proposed new Jewish state would include 250,000 Jews and 225,000 Arabs, making it difficult to see how the prospective state's Jewish character was to be maintained. Therefore, the commission suggested a population transfer between the Jewish and Arab states, meaning, as a last resort, the compulsory transfer of Arabs out of the Jewish state (*Palestine Royal Commission Report*, Chapter XXII, paras. 39, 43, 390 (statistics), 391; Keay, *supra* note 9, at 252). This proposal was clearly incompatible with Articles 2, 6, and the Preamble of the Mandate. The British White Paper of 1939, on the other hand, advocated severe restrictions as far as Jewish immigration and land transfers to Jews were concerned. This was also clearly contrary to the Mandate. Indeed, the majority on the *Permanent Mandates Commission* at the League of Nations declared the new British policy to be "not in conformity with the Mandate" (1939 *Palestine, Statement of Policy, Cmd. 6019.* "Section II, Immigration", "Section III, Land"); *British Policy in Palestine, Report of League Commission, Times, August 18th 1939, at 10*, the article goes on to state that the Commission voted 4:3 to declare British policy as incompatible with the Mandate. For extracts from the Commission's report, see: *Palestine Policy*, TIMES, August 18th, 1939, at 9; Keay, *supra* note 9, at 261.

[287] Dajani, *supra* note 78, at 38; Shlaim, *supra* note 9, at 21; Mansfield, *supra* note 159, at 234; Keay, *supra* note 9, at 365.

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> the essential point of principle is to resist to the last the establishment of Jewish sovereignty in any part of Palestine . . . .
>
> His Majesty's Government have of themselves no power under the mandate to award the country either to the Arabs or to the Jews, or even to partition it between them.
>
> It is in these circumstances that we have decided that we are unable either to accept the scheme put forward by the Arabs or by the Jews, or to impose by ourselves a solution of our own. We have, therefore, reached the conclusion that the only course now open to us is to submit the problem to the judgment of the United Nations.[288]

All the British efforts at disguising their frequently unlawful conduct were to no avail. When Britain finally left Palestine, it could only claim a huge loss of resources, and a reputation tarnished by its inability to impose order in its mandated territory. Undoubtedly, international law had been damaged during this course of events, but even more so Britain's prestige and influence. The French diplomat, Robert de Caix, had predicted as much in 1917. When confronted with British plans for Palestine, he reacted with incredulity: "The question of an English protectorate over a Jewish Palestine scarcely arises . . . . The British government is certainly not dreaming of it . . . . It would, for very thin profit, provoke serious difficulties."[289] The historian Elizabeth Monroe, referring to the Balfour Declaration, subsequently concluded: "Measured by British interests alone, it is one of the greatest mistakes in our imperial history."[290] This history of blatant disregard of international law also goes a long way in explaining the Palestinians' past and current emphasis on issues of legality, often cited by others as evidence of Palestinian intransigence. Compromises will have to be made if there is to be a peaceful future. Without an admission of past wrongs, this will be much more difficult. An

[288] For Ernest Bevin's speech before the House of Commons, see: Hansard, Palestine Conference (Government Policy), HC Deb 18 Feb 1947 vol 433 cc985-994, c988; <http://hansard.millbanksystems.com/commons/1947/feb/18/palestine-conference-government-policy>; extracts also reprinted in *The Times*, "Basis of British Decision on Palestine", 19th February 1947, 4. <http://hansard.millbanksystems.com/commons/1947/feb/18/palestine-conference-government-policy>; extracts also reprinted in *The Times*, "Basis of British Decision on Palestine", 19 February 1947, 4.

[289] Robert de Caix; as quoted by Barr, *supra* note 21, at 35.

[290] Elizabeth Monroe; as quoted by Shlaim, *supra* note 9, at 4.

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acknowledgement of past injustices for what they were, on the other hand, might enable both parties to start anew on the road towards peace.

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Subordinated Debt Under Bail-in Threat

EDOARDO MARTINO[†]

TABLE OF CONTENTS: 1. Introduction; 2. Bail-In, Debt and Creditor's Treatment; 2.1. Raising Capital in the Banking Industry; 2.2. B.R.R.D. and Creditor's Treatment; 3. The Italian Anecdotal Evidence; 3.1. The Narrative and Some Caveat; 3.2. The Market for Subordinated Debt in the Italian Banking System; 4. Empirical Assessment of the Determinants of Subordinated Debt; 4.1. Sample and Variables; 4.2. How to Understand Decision on Subordinated Debt Issuance?; 4.3. Are There Reliable Determinants?; 4.4. Policy Consequences; 5. Convertible Subordinated Bond: A Solution Though Contracts?; 5.1. Contractual Clause for Writing Down and Conversion: a Solving Problem Tool; 5.2. Incentive Structure of Relevant Actors; 6. Conclusions; 7. Appendix.

ABSTRACT: This paper aims to address the role of subordinated liabilities within the new resolution framework resulting from the post-crisis reforms.
In particular, this study starts from the resolution intervention of four Italian banks in November 2015. The legal analysis of that resolution is complemented by an empirical analysis of the determinants of subordinated debt issuances for Italian banks.
From this set of evidence is possible to infer the desirability of a well-functioning and dynamic market for subordinated debt. On the other hand, what clearly emerges is the incompatibility between such a market and the new regulatory framework as it is.
Therefore, the paper, given the compelling arguments showing the inefficiency of a pure mandatory bail-in mechanism for subordinated debt, proposes to complement it with a contractual clause to bail-in subordinated creditors, tailored on coco bonds model, in order to enhance certainty amongst the contractual parties.

KEYWORDS: *Law and Economics; Law and Finance; European Banking Union; Banking Resolution; Subordinated Bonds*

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1. INTRODUCTION

After the global financial crisis in 2007 and the sovereign debt crisis in 2011, the lack of a common regulatory framework for banking supervision and resolution has been identified as one of the main drivers of European, and especially the Eurozone, stagnation.

The European policy maker reacted implementing the European Banking Union (hereinafter E.B.U.)[1] to enhance financial stability and make a step forward towards a genuine economic and monetary union.[2] The new E.B.U. consists of three main pillars:[3] a Single Supervisory Mechanism for the Eurozone (hereinafter S.S.M.),[4] a new Deposit Guarantee Scheme (hereinafter D.G.S.)[5] and a new framework for the resolution of distressed banks.[6]

Within the resolution intervention, the bail-in tool attracted the utmost attention of both media and scholars.[7] A bank bail-in[8] is a tool that the Resolution Authority can employ once a resolution is triggered. The power to write down (Article 63 (1)(e) B.R.R.D.) or convert into ordinary shares (Article 63 (1)(f) B.R.R.D.) eligible liabilities issued by the bank under resolution constitute a bail-in. Therefore, a bail-in represents a balance sheet operation

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[1] *See* the 'Conclusions document' of the European Council (28/29 June 2012).

[2] *See* HERMAN VAN ROMPUY, TOWARDS A GENUINE ECONOMIC AND MONETARY UNION (2012).

[3] *See* DANNY BUSH & GUIDO FERRARINI, EUROPEAN BANKING UNION (2015).

[4] Council Regulation 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions, 2013 O.J. (L 287), 63.

[5] Directive 2014/49 of the European Parliament and of the Council of 16 April 2014, on deposit guarantee schemes, 2014 O.J. (L 173), 149.

[6] Directive 2014/59, of the European Parliament and of the Council of 15 May 2014 Establishing a Framework for the Recovery and Resolution of Credit Institutions and Investment Firms and Amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council, 2014 O.J. (L173), 190, and – specifically for the Eurozone - Single Resolution Mechanism – Regulation 806/2014, of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No 1093/2010, 2014 O.J. (L 225), 1.

[7] For a survey about the challenges stemming from bail-in, see Goodhart, Charles; Charles Goodhart & Emilios Avgouleas, *A Critical Evaluation Of Bail-Ins As Bank Recapitalisation Mechanisms*, SSRN, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2478647 (Aug. 12, 2014).

[8] *See* Paul Calello & Wilson Ervin, *From bail-out to bail-in*, THE ECONOMIST, Jan. 28, 2010.

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to recapitalize and restore the viability of the distressed institution.[9] In this way, the State should not be "forced" to bail those banks out and, consequently, would avoid burdening tax-payers with bank savings.[10]

The specific objective of this paper is to address the consequences that the new resolution tools have on subordinated liabilities market in a dynamic perspective; meaning that the paper considers not only how the new regulation affects a particular class of creditors, but also whether such new framework incentivizes a shift in the characteristic of subordinated bonds and bondholders and the expected outcome of the whole process.

This paper discusses the desirability of a developed market for subordinated bonds and – at the same time – the inefficiency of a purely mandatory debt conversion regime. Eventually, a contractual model tailored on the contingent capital instrument is proposed to make all the actors involved better-off.

The structure of the paper is as follows: Section § 2 provides an introduction to the banks' financial structure and creditors' safeguards in case of bail-in, as disciplined in the Bank Recovery and Resolution Directive (hereinafter B.R.R.D). Section § 3 analyzes an anecdotal evidence from Italy, where the Bank of Italy, along with Ministry of Economic and Finance, resolved four banks in November 2015. The key point of that resolution intervention was, indeed, writing down the bank subordinated debt. Section § 4 tries to test empirically which are the determinants of subordinated debt, using a sample of Italian banks and listed subordinated bonds. Finally, Section § 5 discusses the incentives for banks and bondholders to include in their agreement a clause to convert and/or write-down the credit when a given trigger event occurs (Section § 5).

Throughout this paper the so-called "Law and Economics" methodology is widely applied. This basically means that the legal analysis concerning bail-in and subordinated bond is closely tied to the analysis of

[9] *See* Simon Gleeson, Special Paper, *Legal Aspects Of Bank Bail-Ins*, 2012 LONDON SCH. ECON. FINAN. MKT. GROUP PAPER SERIES ¶ SP205.
[10] During the 2007-08, crisis almost 37% of aggregate E.U. Member State GDP was spent to avoid banks failure. *See* E.C.B. Report on EU Banking Structures, (Sept. 2010), https://www.ecb.europa.eu/pub/pdf/other/eubankingstructures201009en.pdf?cd7ac9e5cf703dabf86f35ac0140f225.

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economic consequences of the legal framework,[11] borrowing from basic microeconomic theory and econometrics.

2. BAIL-IN, DEBT AND CREDITOR'S TREATMENT

2.1 RAISING CAPITAL IN THE BANKING INDUSTRY

Before starting any analysis of banks bail-in and its impact on subordinated debt, it seems to be wise taking a step back and examining how banks raise their capital, i.e.: how they make decisions concerning the source for funding firm's activities. In fact, the decisions about capital and debt structure are going to be a crucial aspect of the paper.

An intuitive division is usually drawn between debt and equity, anyhow – given the large variety of debt and equity instrument available – the source of funding can be better visualized as a vector ordered according to the loss absorbency capacity of each particular financial instrument: clearly, pure equity instruments have a higher loss absorbency capacity in case of failure and debt tools have lower and lower capacity to absorb losses. From the investor's standpoint, a greater loss absorbing capacity means a higher risk profile of the investment.

For standard economic reasoning, in deciding its capital structure, each firm strives to find a mix of different capital instruments which maximize the difference between marginal cost and marginal benefit of capital (e.g.: tax incentives, cash flow incentives).[12]

The first issue that has to be highlighted is that a bank's financial structure has many peculiarities compared to non-financial corporations. These can be explained by focusing on two aspects: the role of financial structure for banking activity and the social cost of banks failure. Indeed, the financial structure of banks is *per se* highly leveraged, as the core business of

[11] For an extensive introduction see ROBERT D. COOPER, LAW AND ECONOMICS (Pearson Education eds., 6th ed. 2011). ; *see also* Louis Kaplow & Steven Shavell, *Economic Analysis Of Law*, *in* 3 HANDBOOK OF PUBLIC ECONOMICS 1661-1784 (Martin Feldstein & A.J. Auerbach eds., 2002).
[12] *See* Jianping Zhou et al., *From Bail-out to Bail-in: Mandatory Debt Restructuring Of Systemic Financial Institutions*, 12/03 INT'L MONETARY FOUND STAFF DISCUSSION NOTES, Apr. 24, 2012, at 21.

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commercial banks is to transform short term lending (mostly deposits) into long term borrowings. In other words, capital structure is part of what banks do and not only the result of a strategy to raise funds.[13] Moreover, since bank activities have a systemic importance for economic stability,[14] the social cost of banks bankruptcy is by far more severe than for every other kind of corporation.[15]

Any policy suggestion has to carefully consider those two aspects in making proposals to reform banks capital structure whose purpose is to enhance the loss absorbency capacity of banks' liabilities.

After the global financial crisis, (too) high leverage in banks' balance sheets was intensively criticized, and several scholars proposed to set a minimum requirement of equity far higher than the Basel III requirements. The underlying assumption of most of those proposals is the belief that gathering debt is not cheaper than raising equity.[16] This position borrows from Modigliani and Miller's Indifference Propositions, according to which – assuming "no cost of bankruptcy" and "perfect information" – the cost of raising capital is independent of the debt/equity structure of the firm.[17] The departure from that proposition generates a huge stream of literature on corporate finance which will be helpful later on, in the empirical analysis of determinants of subordinated debt issues. In fact, the "no cost of bankruptcy" and the "perfect information" assumptions, which represent the baseline of the Modigliani and Miller's model, turn to be rather unrealistic, especially for the banking sector.

Furthermore, increasing the share of equity in banks financial structure cannot be considered a policy goal per se. In fact, the first-order purpose is to enhance loss absorbency capacity of bank liabilities and, hence, make them more resilient. Thus, in governing future financial crisis, the debt shall play a

[13] *See* Paul Davies, *The Fall And Rise Of Debt: Bank Capital Regulation After The Crisis*, 16 EUR. BUS. ORG. L. REV., 491, 500 (2015).
[14] *See* Olivier Blanchard, Giovanni Dell'Arriccia & Paolo Mauro, *Rethinking Macroeconomic Policy*, 42 J.MONEY, CREDIT AND BANKING 199, 206 (2010).
[15] *See*, for instance MATEJ MARINC & RAZVAN VLAHU, THE ECONOMICS OF BANK BANKRUPTCY LAW (2011).
[16] *See, e.g.*, ANAT ADMATI & MARTIN HELLWIG, THE BANKERS' NEW CLOTHES: WHAT'S WRONG WITH BANKING AND WHAT TO DO ABOUT IT (updated ed., 2014).
[17] *See* Franco Modigliani & Merton Howard Miller, *The Cost Of Capital, Corporation Finance And The Theory Of Investment*, 48 THE AM. ECON. REV. 261-297 (1958).

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role in absorbing losses, and this can be considered the overarching policy goal of the bail-in.[18]

For what specifically concerns subordinated debtholders in banks, their role was highly studied at the beginning of the millennium, during the discussion preceding the Basel II agreement, as a tool to enhance bank's governance via market discipline mechanism.[19] A certain consensus arose around the fact that imposing market discipline via subordinated debt is technically feasible, even though the market discipline mechanism was disturbed by the implicit guarantee of the sovereign on domestic banks solvency.

Although those represent quite outdated evidence, they acquire a new importance thinking that the new E.B.U. mainly aims to eliminate both the implicit guarantee of domestic sovereignty and the "too big (or too complex, international, important) to fail" policy. Therefore, considering that evidence and the new European institutional framework, a considerable improvement in market discipline mechanism via subordinated debt can be predicted, given the greater incentives to fully internalize the costs (i.e.: risk) of subordinated bonds,[20] since subordinated bondholders are particularly prone to bear losses in a resolution process.

However, the bail-in tool goes far beyond the mere market discipline mechanism, since it enhances and makes effective the loss absorbency capacity of debt instruments[21].

On the other hand, the role of subordinated debt in the bail-in process there are not straightforward answers, as well noted by Paul Davies:

> Whilst subordinated debt has survived a real-life performance which would have caused most teams to be relegated, its final role in bank capital is not yet absolutely clear. The FSB is the cheer-leader for subordinated debt in resolution [...]. The Bank Recovery and

[18] Gleeson, *supra* note 9, at 267.
[19] *See* Andrea Sironi, *Testing for Market discipline in the European Banking industry: evidence from subordinated debt issues*, 35 J. MONEY, CREDIT AND BANKING 443 (2003) ; *see also* Jürg M. Blum, *Subordinated debt, market discipline and banks' risk taking*, 26 J. BANKING & FIN. 1427 (2002).
[20] Zhou et al., *supra* note 12, at 20.
[21] *See* BASEL COMMITEE ON BANKING SUPERVISION, CONSULTATIVE DOCUMENT PROPOSAL TO ENSURE THE LOSS ABSORBENCY OF REGULATORY CAPITAL AT THE POINT OF NON-VIABILITY (2010) http://www.bis.org/publ/bcbs174.pdf.

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> Resolution Directive of the E.U. requires the issuance of subordinated debt to promote resolution but is circumspect on the actual proportion.[22]

The last remark about the importance of pricing internalization should be devoted to the positive repercussions of reducing the spillover effect from domestic banks to sovereign and vice versa. As incisively noticed by Paul Tucker: "For banking risk, the genie is out of the bottle. If the risk is not priced into bank bonds, it will be priced into government bonds. The people deserve better".[23]

2.2 B.R.R.D. AND CREDITOR'S TREATMENT

The narrative and the policy goals that led to the B.R.R.D. and bail-in is nowadays well known and a systemic introduction on the theme falls well beyond the scope of this paper.[24] Nevertheless, a brief introduction to the principles on creditors' treatment included in the B.R.R.D. is useful both to concretize the theoretical statements made in § 2.1 and to introduce the anecdotal evidence in § 3. Three main aspects are to be discussed: which are the bail-in eligible creditors; what are their safeguards during the resolution process and their role in capital regulation.

The idea itself of the bail-in makes clear that the position of creditors vis-à-vis the bank insiders and the resolution authorities represents one of the key elements of the new framework.[25]

To begin understanding the position of creditors under B.R.R.D., a good starting point is the second part of the recital n. 67: the goal of creditors involvement within the resolution process is to avoid moral hazard of – at least big – creditors, giving incentives to engage in monitoring activities. This

[22] Davies, *supra* note 13, at 510.
[23] Paul Tucker, *The resolution of financial institutions without taxpayer solvency support: Seven retrospective clarifications and elaboration*, CTR. FOR ECON. POL'Y RES. EUR. SUMMER SYMP. IN ECON. THEORY, Jul. 3, 2014, at 1, 10.
[24] To have a good idea of what happened both from a policy and legal perspective see, FINANCIAL STABILITY BOARD, KEY ATTRIBUTES OF EFFECTIVE RESOLUTION REGIMES FOR FINANCIAL INSTITUTIONS,. (2014); Goodhart & Avgouleas, *supra* note 7; Thomas Conlon & John Cotter, *Anatomy of a bail-in*, 15 J. OF FIN. STABILITY 257 (2014); Christos Hadjiemmanuil, B*ank Stakeholders' Mandatory Contribution to Resolution Financing: Principle and Ambiguities of Bail-In*, 2015 EUR. CENT. BANK LEGAL CONF., 225.
[25] *See* Jens-Henrich Binder, *The Position of Creditors Under the BRRD*, BANK OF GREECE CTR. FOR CULTURE (2016).

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rationale holds if and only if creditors are actually capable of monitoring banking activities, i.e.: creditors with sufficient expertise.[26]

Thus, in determining the classes of bail-in eligible liabilities, three guidelines have to be considered: exclude debt holders that threaten the systemic stability in case of write-down or conversion (the so-called runnable liabilities); include debt holders that can successfully fulfill the monitoring task; exempt particular classes of creditors that deserve to be protected for other reasons.

The B.R.R.D. normative strategy consists in granting a general and ex-ante exemption from bail-in to specific groups of creditors (Article 44 (2) B.R.R.D.) and allocate to the Resolution Authority the power to exempt on a case-by-case assessment other liabilities that are theoretically bail-in eligible. The purpose of this case-by-case assessment is to preserve the continuity of critical activities of the resolving bank and avoid the risk of contagion (Article 44 (3) B.R.R.D.).

In particular, a general ex-ante exemption has been granted to depositors whose deposits are covered by the D.G.S. (deposit up to 100,000€); secured liabilities (e.g.: covered bond); liabilities toward client for what concern fiduciary custody of assets; short-term inter-bank operations; wholesale short-term arrangements (e.g.: repos); liabilities toward workers and retail creditors supplying good and services.

Therefore, all the other liabilities fall within the scope of bail-in, i.e.: the resolution authorities have the power to write off or convert them, according to the safeguards of article 34 of the Directive:

1) creditors bear losses after shareholders according to the order of priority of their credits under classical insolvency procedure (Article 34 (1)(b));

2) within each class, creditors are treated in an equitable manner (Article 34 (1)(f));

[26] *Cf* On this instance GÖTZ, Martin R., et al. Should the marketing of subordinated debt be restricted/different in one way or the other? What to do in the case of mis-selling? Goethe University Frankfurt, Research Center SAFE-Sustainable Architecture for Finance in Europe, 2016.

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3) creditors cannot bear higher losses than would have been incurred under normal insolvency procedure (no creditor worse-off principle - Article 34 (1)(g)).

The application of the first two principles, apart from some ambiguities[27] and difficulties in the coordination of likely divergent national legislations, appear quite straightforward. On the other hand, the no-creditor-worse-off principle (hereinafter N.C.W.O.) creates much more doubts and implementation issues. Moreover, it is crucial to analyze this principle in order to understand what will be the likely role of subordinated debt in the new institutional framework of banks resolution.

The N.C.W.O. principle asks the resolution authority to make a counterfactual assessment, establishing (Article 74) the value of bailed-in liabilities that would have resulted from the normal insolvency procedure. This hypothetical value represents the minimum level of protection for creditors;[28] but, as in all the cases, requires a difficult counterfactual assessment, thus serious effectiveness concerns might arise.[29]

These concerns, which are surely serious and well-grounded, can be approached in a wholly different way, looking at the N.C.W.O. principle as a substitute for the lack of ex-ante safeguards (vote, court hearing, public consultation, etc.) for creditors.[30] To better grasp the economic rationale of the latter statement, the very first step is to transpose the N.C.W.O. protection into the classic Law and Economic trade-off between "Property Rule" and "Liability Rule".[31]

First of all, the underlying entitlement that N.C.W.O. principle wants to grant shall be defined as follows: "In the B.R.R.D., bailed-in creditors are entitled not to suffer higher losses compared to a liquidation scenario"; therefore, the only relevant point to be answered is: how to enforce such an entitlement? In this instance, the entitlement is not protected through an

[27] Hadjiemmanuil, *supra* note 24, at 225-248, 241-244.
[28] Binder, *supra* note 25, at 10.
[29] *See* George Jacobs & David Mitchell, *The no-creditor-worse-off principle from a valuation perspective: standing in the shoo of a hypothetical liquidator*, 29 BUTTERWORTH'S J. INT'L BANKING AND FIN. L. (2014).
[30] Gleeson, *supra* note 9, at 265.
[31] *See* Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules and Inalienability: One View of the Cathedral*, 85 HARV. L REV. 1089 (1972).

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absolute and ex-ante mechanism that prevents creditors to be worse-off, which in Calabresi and Melamed taxonomy is called "property rule". Nevertheless, creditors are still protected through a different mechanism. In fact, the N.C.W.O. principle acts as a blueprint that should guide the resolution authority's activities plus – and especially – as ex-post "liability rule" that assure the compensation of creditors worse-off in the resolution process (as provided by Article 75).

Assuming a costless litigation procedure, the economic outcome stemming from a property and liability rule will be equivalent for the creditors. If the latter assumption is relaxed, the rationale behind such an institutional design can be summarized as follows: bail-in represents a value-creating process compared to the traditional insolvency procedure. In a nutshell, the reduction in transaction costs overweight the positive cost of administrating the Justice.

Considering the time constraints under which a bail-in shall be applied and the value of systemic stability, the approach of European regulator makes a lot of sense from a social welfare standpoint.

Finally, to properly grasp the role of debt – and thus creditors – in the E.B.U. mechanism, a brief overview on financial structure regulation contained in B.R.R.D. has to be presented.[32] First of all, Article 45 B.R.R.D. provides that institutions shall meet at all times a minimum requirement of bail-in eligible liabilities (hereinafter M.R.E.L.).

Article 45 § 4 lists the necessary characteristic to consider a liability as eligible: be issued and entirely paid up; not deriving from infra-group operation; have a remaining maturity of at least one year; not arising from a derivative or a deposit covered by D.G.S.

[32] Anyhow, the core of the financial structure regulation is contained C.R.R./C.R.D. IV package represents the European implementation of Basel III accords. (For a survey of the main regulatory features of C.R.R./C.R.D. IV), see Rainer Masera, *CRR/CRD IV: the trees and the forest*, SSRN, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2418215; (On the possible overlaps and inconsistencies between BRRD and CRR/CRD IV regulation) *see* Bart Joosen, *Bail in Mechanisms in the Bank Recovery and Resolution Directive*, SSRN, https://papers.ssrn.com/sol3/Papers.cfm?abstract_id=2511886.

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In this instance, the approach of E.U. legislator appropriately departs from the one-size-fits-all paradigm.[33] Indeed, Article 45 (6) B.R.R.D. provides several criteria to the resolution authorities to determine a specific M.R.E.L. for each institution.[34]

Another relevant piece of this complex puzzle is a document about Total Loss Absorbency Capacity (hereinafter T.L.A.C.) for Systematically Important Financial Institutions (hereinafter S.I.F.Is.), issued by Financial Stability Board (2015). F.S.B. suggests setting a minimum fix requirement of bail-in eligible liabilities between sixteen and twenty percent of risk-weighted assets (hereinafter R.W.A. (Pillar 1) plus an adjunctive buffer to be determined on an individual basis (Pillar 2).[35]

Nonetheless, for what is here of interest, subordinated liabilities are certainly part of eligible liabilities if the remaining maturity period is longer than one year. At the same time, they can or cannot be part of the regulatory capital (as Additional Tier 1 or Tier 2) depending on whether the tight Capital Requirements Regulations (hereinafter C.R.R.) standards are fulfilled.

The next section is going to apply this theoretical and normative framework to an Italian case study of November 2015, when four medium-small banks were resolved by the National Resolution Authority (i.e.: Bank of Italy) and the role of subordinated debt was crucial.

[33] The one-size-fits-all approach is, instead, adopted by C.R.R./C.R.D. IV package in order to establish a consistent internal market for banks. This approach has been widely criticized since it artificially creates higher compliance costs for medium and small banks, favouring S.I.F.Is. which can enjoy economies of scale.

[34] The European Banking Authority implemented a Draft Regulatory Technical Standards to concretely implement such criteria, *see* EBA FINAL Draft Regulatory Technical Standards on criteria for determining the minimum requirement for own funds and eligible liabilities under Directive 2014/59/EU, EBA/RTS/2015/05, final (3 July 2015); *see also* EBA Interim report on MREL, Report on implementation and design of the MREL framework, EBA-Op-2016-12, (19 July 2016). The base to determine the bank specific requirement is the "own fund requirement" provided by C.R.R. plus any additional requirement to hold own funds in excess. From this starting point, the Resolution Authority can increase or even decrease the amount of M.R.E.L. considering the risk profile, the business model and the funding model of each institution.

[35] The conformance period is not sure yet, but not before 2019. The application of T.L.A.C. standards is consistent with M.R.E.L., even though in other instances, the minimum requirement pursuing B.R.R.D. can substantially deviate from T.L.A.C. standards.

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3. THE ITALIAN ANECDOTAL EVIDENCE

3.1. THE NARRATIVE AND SOME CAVEATS

The 21st November 2015, the Bank of Italy resolved four Italian territorial banks via "Sale of goods" tool to a bridge entity. The day after, the bureaucratic process to establish the bridge banks was speeded up by the government with the so-called "Bank Saving Decree" (D.L. n. 183/2015).

The four resolved banks are Banca Marche, Banca Popolare dell'Etruria e del Lazio, CariChieti and Cassa di Risparmio di Ferrara who together used to hold 1% of national deposits[36]. Despite the size of these banks being rather small, considering the structure of the Italian entrepreneurial system, their viability of was crucial (*see* Agostino et al., 2011), since those are "territorial" banks, coming from a history somehow related to cooperative credit. Therefore, the stability and continuity of the credit lines toward S.M.Es. within their geographical area assumed an importance far beyond the actual amount of deposits or the size of their assets.

The Bank of Italy, following the strategies arranged in the Resolution Plans, created four bridge banks and transferred to them all the assets and liabilities, except for equity and subordinated debt.[37] A procedure for selling the four bridge institutions has already started, and Bank of Italy is striving to conclude it as soon as possible.

On the other hand, for the sake of administrative efficient, only one Asset Management Vehicle,[38] which can be labeled as 'Bad Bank',[39] has been created, gathering all the equity and subordinated debt of the resolved banks

[36] *See* Lorenzo Stanghellini, *The Implementation of the BRRD in Italy and its First Test: Policy Implications*, 2 J. FIN. REG. 157, 158 (2016); *see* also Donato Messineo, *Il provvedimento «salva-banche»: il trattamento di azionisti e creditori nella nuova disciplina delle crisi bancarie* [The "Salva-Banche" intervention: shareholders and creditors treatment in the new banking crisis framework], 36 QUADERNI COSTITUZIONALI 102 (2016).
[37] The Slovenian Supervisory Authority followed the same strategy in 2013. Recently E.C.J. ruled for the legitimacy of bailing-in subordinated liabilities. *See* Case C-526/14, 19th July 2016.
[38] Directive 2014/59, of the European Parliament and of the Council of 15 May 2014 Establishing a Framework for the Recovery and Resolution of Credit Institutions and Investment Firms and Amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council, 2014 O.J. (L173) 4, 5.
[39] Stanghellini, *supra* note 36, at 159.

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on the liabilities side and some non-performing loan on the asset side.[40] The National Resolution Fund owes the capital of both good and bad banks.[41] From a balance sheet perspective, the situation of the former banks, the new bridge banks, and the bad bank is summarized in Table 1.[42]

Balance Sheet Situation

Data are simply translated from Bank of Italy 2015:5 - Data in billion €

Bridge Banks - Aggregted Data			
Assets		Liabilities	
Loans, Investment, other assets (non-performing loans are not present)	24,5	Deposits, bond and other financial instruments	27,8
Credits v s. Bad Bank (guaranteed by Resolution	1,5	Equity (Owed by Resolution Fund)	1,8
Cash	3,6		
Total	**29,6**	**Total**	**29,6**

New Banca delle Marche			
Assets		Liabilities	
Loans, Investment, other assets (non-performing loans are not present)	12,4	Deposits, bond and other financial instruments	14,3
Credits v s. Bad Bank (guaranteed by Resolution	0,9	Equity (Owed by Resolution Fund)	1
Cash	2		
Total	**15,3**	**Total**	**15,3**

New Banca dell'Etruria e del Lazio			
Assets		Liabilities	
Loans, Investment, other assets (non-performing loans are not present)	6,1	Deposits, bond and other financial instruments	6,7
Credits v s. Bad Bank (guaranteed by Resolution	0,3	Equity (Owed by Resolution Fund)	0,4
Cash	0,7		
Total	**7,1**	**Total**	**7,1**

New Cassa di Risparmio di Chieti			
Assets		Liabilities	
Loans, Investment, other assets (non-performing loans are not present)	3,1	Deposits, bond and other financial instruments	27,8
Credits v s. Bad Bank (guaranteed by Resolution	1,5	Equity (Owed by Resolution Fund)	1,8
Cash	3,6		
Total	**3,4**	**Total**	**3,4**

New Cassa di Risparmio di Ferrara			
Assets		Liabilities	
Loans, Investment, other assets (non-performing loans are not present)	2,9	Deposits, bond and other financial instruments	3,5
Credits v s. Bad Bank (guaranteed by Resolution	0,2	Equity (Owed by Resolution Fund)	0,2
Cash	0,6		
Total	**3,7**	**Total**	**3,7**

Bad Bank			
Assets		Liabilities	
Non-Performing Loans	1,5	Debt Vs. Bridge Banks	1,5
Cash	0,1	Equity (Owed by Resolution Fund)	0,1
Total	**29,6**	**Total**	**29,6**

Table 1 – Balance-sheet situation for resolved Bank, 22nd November 2015.

[40] Given the systemic relevance of non performing loans in Italian Banking System, currently there are proposals to make that "Bad Bank" the Italian systemic bad bank to cope with future possible resolution interventions.
[41] The Asset Management Vehicle has been established by the National Resolution Fund, which was – in turn – created few days before the resolution intervention, pursuant to Articles 45 and ff. of the D.Lgs. n. 180/2015.
[42] BANK OF ITALY, *Information about the crisis solution of Banca Marche, Banca Popolare dell'Etruria e del Lazio, CariChieti and Cassa di Risparmio di Ferrara* (*Informazioni sulla soluzione delle crisi di Banca Marche, Banca Popolare dell'Etruria e del Lazio, CariChieti e Cassa di Risparmio di Ferrara*) (2015).

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Therefore, Bank of Italy applied a de facto bail-in, even though the legal instrument currently employed is different since the full-speed bail-in regulation entered into force only on the 1st January 2016. Thus, the relevant institutional framework is the 2013 Banking Communication on "burden sharing".[43]

For some obscure reasons very little has been written on this argument by Italian scholars so far.[44] Hence, this paper also wants to try filling such a gap. First of all, this resolution intervention dealt with the idiosyncratic crisis of relatively small banking institutions, while – in the previous Section –the importance of coping with a systemic crisis of S.I.F.Is. was stressed.

The crisis came from serious mismanagements of all the four resolved banks; indeed, all the four banks were already subjected to severe supervisory intervention by the Bank of Italy. The only "systemic" aspect of the crisis is the crucial role of non-performing loans, which represents one of the central problems of Italian banking system. In fact, during the IV quarter of 2015, the non-performing loans amount was approximately €350 billion, representing almost the 20 % of total loans.[45]

This contingency reflects and fosters many concerns around the actual effectiveness of bail-in as an on-going concern: an excellent tool for mostly idiosyncratic crisis, as substitute of liquidation; but presenting a high risk to be useless or even harmful in case of resolution of big institutions in systemic crisis.[46]

Currently, there are no counterchecks, but it is reasonable to think that the strategy of resolution authorities shall consist in "playing tough" with small distressed institutions in the next couple of years to engender a credible threat and furnish the right incentives to maintain banks viability. In a

[43] Commission Communication on the Application, from 1 August 2013 , of State Aid Rules to Support Measures in Favour of Banks in the Context of the Financial Crisis ('Banking Communication'), 2013 O.J. (C 216) 1.
[44] *See* Antonella Antonucci, *Fra Opacità E Regole Tossiche: Il Ruolo Degli Scenari Probabilistici. Scritto per Il Convegno 'Salvataggio Bancario E Tutela Del Risparmio' [Between Opacity And Toxic Rules: The Role Of Probabilistic scenarios. Written For The Conference'Banking Rescue And Saving Protection']*, RIV .DIR. BANC., Feb. 2016, at 1.; Stanghellini, *supra* note 36; Messineo, *supra* note 44.
[45] BANK OF ITALY, *Statistical Bulletin* – quarter 1. (2016).
[46] *See* Goodhart & Avgouleas, *supra* note 7, at 20; MCANDREWS, James, et al. *What Makes Large Bank Failures So Messy and What to Do about It?*. Economic Policy Review, Forthcoming, 2014.

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nutshell: the best bail-in for S.I.F.Is. is the bail-in that will never happen because of the credible threat established by the regulatory framework itself.

The resolution intervention has been costless for taxpayers so far since the Resolution Fund provided the liquidity to guarantee the continuity of critical activities, via an advance payment by Unicredit, Banca Intesa SanPaolo e UbiBanca.[47] Thus, the policy goal of avoiding taxpayers' expenditures for banks resolution seems to be – at least for the moment – achieved.

As anticipated above, subordinated bonds played a crucial role: they have been fully allocated to the bad bank as the offset for the non-performing loans (see again Table 1). The Italian Resolution Authority (Resolution Unit of Bank of Italy) publicly admitted that the operation intentionally took place in the window between the B.R.R.D. transposition within the Italian legal system[48] and the 1st January 2016, when bail-in entered into force. So that, it was possible to avoid both the standard atomistic liquidation and the use of the "full bail-in tool".[49] The concerns about using bail-in arose from the fact that under bail-in regime a substantial amount of non-subordinated debt should have been written off. Thus, the political choice of the Resolution Authority, along with Ministry of Economy and Finance, was to use subordinated debt as a cushion to protect senior creditors.

The transitory regime in part justifies and explains this approach: people that invested in non-subordinated bond before the "burden-sharing" document and the B.R.R.D. drafts were not able to fully internalize the risk of the financial instruments they were buying because of the previous distorted incentives on which they relied.[50]

[47] *See* BANK OF ITALY, Information about the crisis solution of Banca Marche, Banca Popolare dell'Etruria e del Lazio, CariChieti and Cassa di Risparmio di Ferrara (Informazioni sulla soluzione delle crisi di Banca Marche, Banca Popolare dell'Etruria e del Lazio, CariChieti e Cassa di Risparmio di Ferrara) (2015).
[48] D.Lgs. n. 180/2015 and D.Lgs. n. 181/2015.
[49] *See* BARBAGALLO, Carmelo. *Camera dei deputati – Indagine conoscitiva sul sistema bancario italiano. Audizione di Carmelo Barbagallo. Capo del Dipartimento Vigilanza Bancaria e Finanziaria Banca d'Italia [Italian Chamber of Deputies – Cognitive survey over Italian banking system. Hearing of Carmelo Barbagallo. Chief of Banking and Financial Supervisory Department, Bank of Italy]* (Dec. 9, 2015), p. 9.
[50] It is important to note that "Trust" is an informal institution that has a great importance in social behaviors and, at the same time, is particularly troublesome and time-consuming to generate in the society. See e.g., PINOTTI, Paolo. *Trust and regulation: addressing a cultural bias*. Bank of Italy Temi di Discussione (Working Paper) No, 2009, 721.

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Nonetheless, those arguments can be generalized, at least up to a certain extent. In fact, there is a misalignment between bail-in eligible liabilities and the loss absorbency capacity of each of them, as designed by C.R.R./C.R.D. IV package. Thus, for resolution authorities writing down senior creditors claims will never be an easy call[51] and it is plausible that resolution policy will opt for permanently using subordinated debt as a cushion even when the resolution mechanism will work at full speed.

Despite the protection of senior creditors, the resolution has been greatly criticized. The widely perceived unfairness was mainly due to severe mismanagement in the allocation of those financial instruments. For example, resolved banks commonly asked their clients to subscribe subordinated bonds to open or keep credit lines for SMEs,[52] as an informal collateral, without giving proper information about their risk profile, breaching *de facto* the standards established by Markets in Financial Instruments Directives (hereinafter MiFID).[53]

As current final episode of this narrative, the Italian government provided for a reimbursement procedure for a portion of written-off debt holders.[54] The overall result of this refund operation consists of shifting a part of the resolution burden from bank insiders to the banking system as a whole, via the National Resolution Fund, realizing a sort of "private bail-out" intervention. This aspect, together with the use of subordinated debt to protect senior creditors, can give an idea of the future resolution policies.

As was expected, the conclusion of the story after the completion of the sale of the bridge institutions, will be that the new, viable, banks will not be strictu sensu "territorial" anymore. In fact, three out of four banks have been acquired by UBI Banca, while – at the time I am writing – there are still

[51] *See* Binder, *supra* note 25.
[52] On the risk of allocating debt to bank's clients, even for the overall stability of the institution, see Stanghellini, *supra* note 36, at 161.
[53] *See* for an extensive introduction about MiFID, JEAN-PIERRE CASEY & KAREL LANNOO, THE MIFID REVOLUTION (2009). For what specifically concerns MiFID and subordinated debt, see Gotz et al., *supra* note 26.
[54] According to the procedure depicted in the D.L. n. 59/2016 – "Urgent measures for liquidating banks investors".

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ongoing negotiation with BPER for the last good banks still managed by the Bank of Italy.[55]

It is important to notice how the acquirers of the good banks are going to pay just a symbolic price for the acquisition. The main issues on which the parties have been contracting about are the management of non performing loans (hereinafter N.P.L.) and the level of additional Common Tier Equity 1 (hereainafter CET1) to be raised in order to be able to sustain those acquisitions.

This conclusion could cause some problems to the S.M.Es. network and their funding costs; moreover, the lack of trust resulting from this story will not be easy to fix. Nonetheless, even if counterfactual assessments are always difficult to make and prove, the intuition is that the situation could have been far worst without this resolution intervention since the atomistic liquidation of the resolved banks would have threatened the continuity of the territorial S.M.Es. themselves.

3.2 THE MARKET FOR SUBORDINATED DEBT IN THE ITALIAN BANKING SYSTEM

To link the narrative of the resolution intervention of § 3.1 and the empirical analysis of § 4 is crucial to understand the scope and the functioning of the Italian market for banks subordinated bonds. Some figures about the market itself can give a quite accurate idea of what we are dealing with.

The 31st October 2015, the issued subordinated bond amounted to €67,2 billion of which €8.5 billion, i.e.: about 13% of the entire amount of issued bonds, were held by the issuing banks themselves. Thus, there were €58,7 billion of bonds floating in the market, of which over the 50% allocated to individual investors and households (thirty-one billion).[56]

Again, some figures might facilitate the understanding of what €67 billion mean in the Italian banking system: the total assets of the seventh

[55] Insofar, there are no ufficial documents nor discosure of contractual terms, but only an official press release from the Bank of Italy, (2015) https://www.bancaditalia.it/media/comunicati/documenti/2017-01/cs_good_bank.pdf.
[56] *See* BANK OF ITALY, *Informazione sui detentori di obbligazioni subordinate [Information about subordinated bond holder]. Unfortunately there are no data available on the share who are also client of the issuing bank.*

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Italian banking group (Banco Popolare dell'Emilia Romagna) amount to €61 billion and the total regulatory capital of the first Italian banking group (Unicredit) amounts to €55 billion.

Moreover, investing in banks' subordinated bonds seems to be very popular when looking at household investment preferences. In fact, in 2015 the volume of Italian household financial investments is €3,848 billion of which 727 are bank deposits, and only 60 billion are listed stocks,[57] while 30 are in banks subordinated debt (i.e.: almost 1% of total investments).

A possible explanation of those figures could be that Italian households are highly risk-adverse and under the previous regime, where the State indirectly subsidized banks bonds through the implicit guarantee of bail-outs, this type of investment attracted them since the risk profile was close to zero and the interest rate was about 1.5 % higher than that of senior bonds.[58]

After the new regulatory stream, some variations were predictable; nevertheless, the events of November 2015 triggered what seems to be an enormous revolution. Indeed, those resolution interventions made clear to everybody, and in particular to small and medium banks under the direct supervision of Bank of Italy, that the new European rules – despite all the effectiveness and efficiency concerns – would have been to be actually applied.

First of all, it is necessary to distinguish between the biggest banks in the system and all the others. In fact, for Intesa San Paolo and Unicredit, which are the only two Italian S.I.F.Is., the market for subordinated bonds is going to disappear because of the lack of supply. Intesa has not issued retail subordinated bond in the last four years, while Unicredit launched a huge buyback campaign for floating subordinated debt from the beginning of 2016.[59]

Those are the only two Italian commercial banks that can afford to shut down that market, thanks to multiple funding sources and greater stability. For

[57] *Accord*, Banca d'Italia, *Gli investimenti delle famiglie italiane: solo l'1,5% è destinato alle azioni quotate [Investments of Italians families: just 1,5% addressed to the Stock Exchange]*, IL SOLE 24 ORE, March 27, 2015, at 3.
[58] A partial empiric confirmation of this substitability effect can be found in Regression Table 1 (Appendix), where "Bond Spead" depict a sort of beauty contest between Subordinted Debt issued by banks and 10y Italian Governamental Bond.
[59] Unicredit offered to buy back up to 1.8 billion of subordinated bonds. According to the last information available the share of adhesion was over 60%. Compare http://www.ft.com/cms/s/0/f5d8fb6a-c04b-11e5-9fdb-87b8d15baec2.html.

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all the other banks the stream of financial reforms affects the demand side and the pricing mechanism.

Holders of banks subordinated debt (Data in billion €)		
Holders	Amount	Share
- Italian Banks	3	5,11%
- Italian Households	31	52,81%
- Italian Institutions of which	8,1	13,80%
other financial intermediaries	3,1	5,28%
investment funds	2,2	3,75%
companies	2,2	3,75%
- Foreign investors	13,2	22,49%
- Not classified	3,4	5,79%
Total	58,7	100,00%

Table 2 – Banks Subordinated Debt Market in Italy. Bank of Italy, 2015b

On one hand, the demand side of the market for subordinated debt, even if it is an ongoing process and no specific data are now available, a simple and straightforward prediction can be stated: the increased risk profile will cause a shift from households and non-professional investors to professional and institutional investors.

On the other hand, a more accurate description – even though not systematic – of the price for subordinated bonds is feasible since that type of data is more steadily available. Before 22nd November 2015 the average gross yield of a basket composed by eighty-nine subordinated bond was 4.68%. At the beginning of January 2016, the average gross yield of the same bundle of bonds skyrocketed to 6.18%. Moreover, sixteen out of eighty-nine bonds yielded more than 10%, of which seven even more than 20%.[60] The most expensive bonds were issued by banks perceived as particularly vulnerable by the market (e.g.: Monte Dei Paschi di Siena and Banca Popolare di Vicenza), which is consistent with the lack of implicit State guarantee.

Those data appear quite astonishing, but they are – at least in part – to the shock provoked by the resolution intervention of the last November. Thus, to precisely evaluate the actual spread between the yields before and after the

[60] Data from SkipperInformatica. With Nicola Borzi, *Bond subordinati nella bufera: i rendimenti si impennano [Bond subordinated in the storm/blizzard: the profits nose up]*, Il Sole 24 Ore, January 20, 2016Il Sole 24 Ore, (Jan. 20, 2016).

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bail-in regulation, more time is going to be necessary, even though the tendency is clear and indicates a remarkable increase in subordinated bond prices in the long run either.

4. EMPIRICAL ASSESSMENT OF THE DETERMINANTS OF SUBORDINATED DEBT

In the previous Section, the resolution intervention and its first spillover effects were discussed both from the banks, investors and regulatory standpoint; the next step consists in empirically investigating whether the decision of issuing subordinated bonds has some structural determinants. Therefore, the question that this paragraph aims to answer is whether there are reliable determinants that lead a bank to issue subordinated bonds.

This is quite an uncommon step for a legal paper,[61] nonetheless what follows is going to make clear, at least I hope, how an empirical investigation of legal issues can be useful to – in this very case – evaluate the possibility of implementing more tailored resolution interventions on subordinated bonds in the future.

As far as I am aware, there are no specific studies dedicated to the determinants of subordinated bonds in the banking industry, neither for general corporate subordinated bonds. Nonetheless, the corporate finance literature[62] about determinants of capital and debt structure for non-financial firms is impressively extensive and represents the unavoidable starting point of this analysis.[63] In fact, that literature stems from the departure of Modigliani and Miller irrelevance proposition, as analyzed under Section § 2.1.

[61] Even though "Empirical legal studies" is for sure an expanding and successful field of research. For a sound introduction on this research methodology see ROBERTO M. LAWLESS, JENNIFER K. ROBBENNOLT & THOMAS ULEN, EMPIRICAL METHODS IN LAW (2010).
[62] That stream of literature dealing with funding and capital structure decisions of both financial and non-financial corporations. For a survey and introduction, even though not updated, see e.g., Raghuram G. Rajan & Luigi Zingales, *What do we know about capital structure? Some evidence from international data*, 50 THE J. FIN. 1421 (1995).
[63] In addition, the empirical corporate finance literature generated over time a certain degree of consensus about some standard variables related to the capital structure of non-financial firms. *See e.g.,* Sheridan Titman & Roberto Wessels, *The Determinants of Capital Structure Choice*. 43 THE J. FIN. 1 (1988).; Milton Harris &Artur Raviv, *The Theory of Capital Structure*, 46 THE J. FIN. 297 (1991); Id.; and Murray Z. Frank Vidhan K. Goyal, *Capital structure decisions: which factors are reliably important?*, 38 FIN. MGMT. 1 (2009).

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This represents quite an uncommon approach, since the standard one for banking capital structure is based on capital requirement regulations as the only significant departure from Modigliani and Miller proposition,[64] paying no attention to capital and debt structure of financial firms. Anyhow, stemming from corporate finance literature, there are recent studies focused on banks' capital structure that deviate from the classical approach. Heider and Gropp[65] focused on bank's leverage, showing a high grade of similarity between their empirical evidence and other studies carried out on non-financial firms. Thus, they concluded that capital requirements are not a first order determinant for a bank's capital structure. For what more closely concerns debt structure, Santos[66] showed a cost advantage for larger banks in raising debt which is only partially due to the "too big to fail" policy.

Speaking specifically about subordinated debt, the most useful and enlightening study has been carried out by Zanghini,[67] both for the contents and methodology. He analysed the bank bonds spread, focusing on the role of implicit and explicit public guarantees through the analysis of "Asset swap spread" of different bonds. Moreover, Pop[68] empirically proved the intuitive idea according to which subordinated creditors are more sensitive than seniors to the risk profile of the issuing institution.

Applying all this theoretical and empirical insights to the present case study, the rest of § 4 tries to establish reliable determinants for Italian subordinated debt issuances in the banking industry.

4.1 SAMPLE AND VARIABLES

The analyzed sample consists of twenty-five Italian parent banks that have available balance sheet data on subordinated debt in BankScope Bureau Van

[64] *See* FREDERIC MISHKIN & ADDISON WESLEY, THE ECONOMICS OF MONEY, BANKING AND FINANCIAL MARKETS (6th ed., 2000).
[65] GROPP, Reint; HEIDER, Florian. *The determinants of bank capital structure*. ECB Working Paper Series n. 1096/2009.
[66] SANTOS, João AC. *Evidence from the Bond Market on Banks "Too-Big-To-Fail" Subsidy*. Economic Policy Review, Forthcoming, 2014.
[67] ZAGHINI, Andrea. *Bank bonds: size, systemic relevance and the sovereign.* Working Paper n- 966. Bank of Italy.
[68] POP, Adrian. Market discipline in international banking regulation: keeping the playing field level. *Journal of Financial Stability*, 2006, 2.3: 286-310.

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Dijk DataBase. In building the panel database, the considered time series goes from 2006 to 2015.

Starting from balance sheet data of those banks, the analysis focuses on the listed subordinated bonds issued both in Eurobond and Italian Market, according to the information available in Pillar 3 documents about issued bonds of each bank of the sample. The specific financial data for each of those bonds has been analyzed through Thomson Reuters DataBase.

The final database is made up of 102 bonds issued by thirteen banks. The small number of analyzed banks is due to the fact that most of the small Italian banks issued only retail and non-listed subordinated bonds whose data are not available. Nevertheless, the sample turns out to be quite representative for big and medium Italian banks. Furthermore, some of the results, after a case by case analysis based on economic theory and common sense, can be generalized even for small banks.

Because of the different dates of issue of the analyzed bond, the sample results are unbalanced throughout the time series. Moreover, data on secondary market yields of the bonds were not or only partially available along the time series (427 yield observation out of 626 total ones).

(See Table in the next page)

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	Variable	Oservations	Mean	Std. Dev.	Min	Max
Bond Characteristic	Duration	571	9,36	2,33	5	20
	Volume	626	387215	412,61	5	2000
	Yield	427	6,42	5,42	-1,58	64,43
	Coupon	626	5,40	1,65	0,87	9.5
Bank Characteristic	Bond spread	427	2,52	5,08	-5.91	59,90
	Subordinated debt	621	9855,28	7493,11	299,00	29278,20
	SubDebt/regCapital	621	24,04	6,00	8,85	51,51
	SubDebt/TotLiabilities	621	2,35	0,61	.8267274	4,01
	Total Assets	626	453447,10	357895,10	10765,90	1045612
	Net Income	626	-600,38	4155,97	-13583,20	7356,00
	ROAA	626	-0,19	0,88	-3,92	1,28
	ROAE	626	-4,00	16,22	-88,01	16,86
	NPLratio	623	26,10	15,73	5,67	97,12
	Loans/assets	626	60,85	7,95	49.84	82,23
Regulatory Characteristic	Tier1_ratio	623	10,00	2,24	5.13	14,67
	Capital ratio	623	13,07	2,18	8,00	19,77

Table 3 – Summary Statistics

Finally, the data on duration are biased by the fact that some of the subordinated bonds are perpetual, thus in the summary statistics of Table 3 are shown only the bonds with a defined time duration.[69]

From a methodological point of view, in analyzing the data, the linear regression[70] method is employed. That basically means to check whether the (increasing or decreasing) trend of the dependent variable is somehow correlated with the trend of one or some independent variables, thus establishing correlation linkages. In § 4.3 those correlation linkages are to be discussed in order to draw some policy conclusions. In discussing them a cornerstone is the level of statistical significance of those linkages, meaning the level of certainty that the actual level of correlation is different from zero. As a rule of thumb, a 95% confidence is considered a good threshold to draw reliable inferences.

[69] For a deeper description of the variables used in the study see the Appendix.
[70] All the regressions are run with the Random Effect estimation method, to catch both the cross-sectional and time variances. Random Effect has been preferred over Fixed Effect after running the Hausmann-test. Robust Error estimation has been used as well to avoid heteroskedasticity problems.

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4.2 HOW TO UNDERSTAND DECISIONS ON SUBORDINATED DEBT ISSUANCE?

Using the data set defined above, this study aims to understand what are the drivers of decisions about subordinated debt both from the bank and the investor point of view. In order to do that, the data described in the previous sub-paragraph are used to approximate different aspects concerning the decision of both the issuer and the investor.

For the sake of simplicity, what follows is a mere qualitative description of this process, which explains the variable approximating those decisions (dependent variable) and the variables analyzed to explain such decisions (independent variables). Then, in the footnotes and in the Appendix, the economic and econometric underlying rationale of the models used in the analysis are discussed in more detailed. Throughout the study, the bank's decision of issuing subordinated debt has been disentangled and analyzed under two related but still different perspectives: the decision concerning the overall financial structure of the firm and the decision specifically concerning the structure of regulatory capital.

Firstly, to understand the determinants of these decisions, the data analyzed are related to financial data of the bank (*e.g.*: balance sheet structure; N.P.L. patio etc.); financial data of the specific bond (*e.g.*: yield) and some approximation of the bank-specific role of the regulator.[71] Secondly, the variation on subordinated debt issuances over the last decade is taken into consideration. This is important to understand if economic or legal shocks (*i.e.*: financial crisis and reform implementation) played a decisive role in the subordinated debt market. Practically, the same variables are to be explained; but now only the evolution over time is computed in order to explain the variations. Finally, the issue at stake is further disentangled taking into account the investors' decisions, which are approximated through the yield on the secondary market and the spread between those yields and the yield of ten-year Italian governmental bonds. This proxy makes sense since the average duration of the analyzed bonds is over nine years, thus investing in banks subordinated debt can be considered a close substitute of investing in

[71] For more detailed on the variables used see Appendix, Variable List Table, where a detailed description of the variables is provided.

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Italian Treasury bond, and so it represents the perfect benchmark for the present study.

4.3 ARE THERE RELIABLE DETERMINANTS?

Regression Tables 1, 2 and 3 in the Appendix summarize the empirical findings of the models depicted in the previous paragraph.

The first interesting insight concerns the sharply different outcome in the decisions about financial and regulatory capital structure, indicating that each bank has to face two distinct orders of decisions, following separate aspects.

For what concerns financial structure decisions the 'Capital ratio' and 'Tier1 ratio' parameters sign and magnitude are consistent with common sense: the higher the capital ratio, the higher the subordinated debt ratio; the higher the Tier1 ratio, the lower the subordinated debt structure.

The highly statistical significance of the negative parameter of the dummy "E.C.B. supervision" shows that the less systemic a bank is, the higher the share of subordinated debt. In fact, the S.S.M. entered into force only in 2015. Thus, that variable only indicates the relevance of the requirements to be subjected to direct E.C.B. supervision, which are – indeed – about the systemic importance of the banking institution within European and domestic banking system.

The significant negative parameter of N.P.L. ratio is of particular importance since it is becoming the major issue for the problematic Italian (and even European) banking system. The relatively high-risk profile of the subordinated bonds can explain this evidence: for a bank with a high N.P.L. ratio funding itself by subordinated debt represents a too expensive option.

On the other hand, in deciding the structure of regulatory capital, the banks are remarkably influenced by the spread between the yield of subordinated bonds and the ten-year Italian governmental bond: the higher the spread, the larger the share of subordinated capital. This can be explained

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by the particular attractiveness of investing in bank's subordinated bonds, for the reasons discussed in § 3.2.

Another important result, confirming the E.C.B. supervision requirement as a proxy for systemic relevance, is the negative highly statistical significance of the size indicating that for smaller banks the subordinated debt funding option is more convenient compared to bigger banks.

What is constant throughout all the regressions in Regression Table 1 - Appendix is the remarkably high (99.9% level), though conflicting, significance of two different profitability ratios, namely the "Return on Average Assets – R.O.A.A." and the "Return on Average Equity – R.O.A.E.". In particular, a higher R.O.A.A. is positively correlated with a higher ratio of subordinated debt, while R.O.A.E. is negatively correlated with subordinated debt ratio. Hence, the profitability of the bank is an important argument for issuing subordinated debt: only the above-average performing banks can afford to release a high level of subordinated debt, but still if a bank is highly capitalized (which leads to a high ROAE) the level of subordinated debt decrease. Thus, between equity and subordinated debt, a certain degree of substitutability seems to exist, on top of the regulatory capital threshold.

Finally, another variable which is constantly highly statistically significant and with positive parameter throughout the regressions (always at 99.9% level) is the ratio between loans and assets. Hence, issuing subordinated bonds is a common way to fund, at least in part, marginal loans over the average level of the sample. That represents a crucial contingency since the credit crunch has been considered one of the primary determinates of the Italian (and more generally European) economic stagnation after the global financial crisis; consequently, this finding turns out to be particularly dense of policy implications.[72]

Some of those findings are of particular interests, and their policy implication will be analyzed later on in this chapter. However, to make this

[72] The equations which comprehend all the variable categories prove to fits particularly well to the data, explaining the 50% and 75% of variations, respectively for financial structure and regulatory capital structure decisions.

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analysis as accurate as possible, some further insights can be added thanks to the second and third models introduced in the previous paragraph.

The fact that the high-level subordinated debt issuers have both higher loan-to-asset-ratio and lower N.P.L.-ratio is striking. In fact, for an institution with lower borrowing opportunities is expected to exert a more careful evaluation of the marginal loans, therefore resulting in a lower N.P.L.-ration. A possible explanation is that subordinated debt holders actually monitor better what is going on in the bank, resulting in better choices about marginal borrowers. This is somehow in line with the study carried out by Sironi in 2003;[73] nevertheless, it is in contrast with the actual identity of debt holder underlined in § 3, mostly non-professional retail investors. A plausible alternative explanation is that the correlation between N.P.L. and level of subordinated debt entails a better risk taking by the management of the bank which is determined by unobservables (i.e.: variables that are not included in the statistical analysis). This latter explanation, even though it falls out of the model hereby proposed, seems to be more plausible.

For what concerns the variations over time (Regression Table 2 in Appendix), the regressions show pretty different pictures for the decisions about financial and regulatory capital structure. The latter has an irregular and not always significant path in the first years of the time series, while the coefficient of 2013 and 2014 are highly statistically significant, positive and big in magnitude. Those years were crucial for the implementation of new European Banking framework, with the entrance into force of C.R.D. IV/C.R.R., the proposals of the new Banking Union and the document about Burden Sharing in banking crisis. This evidence confirms the arguments of Chapter § 3 about the role of subordinated debt as a cushion to protect senior creditors.

On the other hand, in the decision about financial structure, the most notable outcome of the time dummy model is the highly statistically significant increase in subordinated debt share during the hardest years of the global financial crisis (2008-2010).

[73] Sironi, *supra* note 19.

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Finally, the regressions shown in Table 7 give a perspective on the investor's point of view when deciding whether to invest in banks subordinated bonds or in something else.

Consistently with common sense and basic economic theory, the higher the class of regulatory capital (i.e.: the greater the loss absorbency capacity of the financial instrument), the higher the yield of the bond. What is less intuitive is that the bond rating variable has the expected negative coefficient though is not statistically significant. The same can be said for the N.P.L. ratio, meaning that investors relied on other types of information or, simpler, on the implicit guarantee of the domestic sovereign. Thus, those regressions perfectly depict the past but have a (hopefully) small capacity to predict what is going to happen in the future, since the old paradigm generates some biases in the regressions.

Nevertheless, there are two elements that are likely to hold even in the future: firstly, the profitability and size of the banks will remain an argument in investor's decisions. Secondly, there is a highly significant but slight cost advantage for bigger issues, which are usually adopted by larger banks, consistently with the findings by Santos (2014). On the other hand, there is a highly significant and substantial negative correlation between yield and bank profitability (measured through R.O.A.A.) which still have a straightforward explanation.

Another intuitive finding, useful to confirm the consistency of the model, is shown in the time series, where the yield of subordinated bonds increased significantly in 2008, when the global financial crisis broke out and, only for the bond spread, in 2011 when the public debt crisis began.

4.4 POLICY CONSEQUENCES

The findings of the present empirical analysis lead to one main policy conclusion, namely: agreeing with I.M.F. in supporting subordinated debt as a

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powerful tool to increase the soundness and resolvability of banking institutions.[74]

In fact, summarizing the evidence shown by the models, the banks that are more likely to issue a high share of subordinated debt (i.e.: finding it a convenient funding decision) are the medium-small banks, which are not systemically relevant and whose level of performance is above average. Given those arguments, creating an institutional framework which is "subordinated-debt-friendly" seems to foster efficiency. Moreover, it is also consistent with the goal of generating a level playing field among European banks as well, reducing the cost-advantage in complying with more requesting regulatory framework joined by bigger banks.[75]

On the other hand, there is no evidence that the act of issuing subordinated bonds itself leads to moral hazard or adverse selection. In fact, issuing subordinated debt can lead to an inefficient outcome if: the supervisory activity is suboptimal, the implicit guarantee of the sovereign on bank solvency still exists, and the enforcement of the subordination clause through resolution tools is uncertain. Assuming an optimal suspensory activity,[76] the implicit guarantee that characterized the last decades should not exist anymore in the new institutional framework;[77] what remains a problem is the level of certainty in enforcement mechanism. This issue will be specifically tackled in Chapter § 5.

Beyond the arguments already discussed, previous empirical findings allow to add two other important aspects supporting the use of subordinated bonds in banks financing. First of all, issuing subordinated debt signals the market that the bank has the appropriate level of soundness to go to the market and sell those bonds at a reasonable price. Second of all, and more important, the higher the level of issued subordinated bonds the higher the level of loans granted. Such a contingency should be highly relevant for the

[74] Davies, *supra* note 13, at 512.
[75] As proved by SANTOS, *supra* note 66.
[76] That is quite an unrealistic assumption, even though the S.S.M. reform improved the quality of supervision toward Eurozone Banks. *See* FERRARINI, Guido A. *Single Supervision and the Governance of Banking Markets*. ECGI-Law Working Paper, 2015, 294.
[77] Still, this assumption is not completely true since B.R.R.D. leaves a certain room for bail-outs intervention: Council Directive 2014/59, art 100, 2014 O.J. (L 173). Nonetheless, for the sake of this analysis this represents a workable assumption.

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European policy makers since there is a broad consensus in considering the credit crunch as one of the crucial determinants of the prolonged economic stagnation of Eurozone.[78]

Chapter 3 showed that current institutions (both formal and informal institutions and their enforcement mechanisms) might lead to a lack of incentives to issue subordinated bonds. Then, this Chapter strengthens the arguments in favor of desirability for a dynamic market for subordinated bonds. Hence, the last step of this paper will be devoted to proposing an institutional framework with an enhanced degree of certainty in the enforcement (i.e.: resolution) phase.

5. CONVERTIBLE SUBORDINATED BOND: A SOLUTION THROUGH CONTRACTS?

Given the uncertainty and unpredictability underlined in the previous sections, the question arising is whether the current institutional framework furnishes efficient incentives to all the relevant agents to foster the resilience of the bank. Borrowing from Douglas North:[79] is the institutional matrix providing a pay-off matrix which leads the actors to act efficiently?

To answer this question, the outcome of the empirical study carried out in Section § 4 has to be combined with some other insights about bail-in in general. First of all, under Article 37 § 10 sub. a, any sort of bail-out operations become lawful if and only if at least the of 8% of the bank's liabilities were written down. Some scholars[80] predicted the tendency to prefer a "private bail-out solution" right after the 8% threshold has been reached. "Private bail-out" solutions indicate all the available mechanisms providing external funds to the distressed bank without a direct State intervention or a market operation.[81]

[78] Juan R. Cuarado-Roura, Ron Martin & Andrés Rodrìguez-Pose, *The economic crisis in Europe: urban and regional consequences,* 9 CAMBRIDGE J. REGIONS, ECON. AND SOC'Y 3 (2016).
[79] Duglas C. North, *Institutions and the performance of economies over time, in* HANDBOOK OF NEW INSTITUTIONAL ECONOMICS 21-30 (2008).
[80] Goodhart & Avgouleas, *supra* note 7, at 20; MCANDREWS, *supra* note 46.
[81] Council Directive 2014/59, *supra* note 77, art. 100 and ff.

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In the second place, the fact that during the 2007-08 crisis the losses of the distressed banks were in average, around 8%.[82] Thus the expected outcome in a 2007 crisis scenario with the new regulatory framework can be depicted as follows: the new regulation determines the need to bail-in the 8% of distressed banks liabilities; therefore, subordinated debt will act, in practice, as a cushion to protect senior creditors.

Piecing all these aspects together, subordinated bondholders suffer a high uncertainty about their investment, and they cannot correctly ex-ante assess this risk. In fact, the investors do not only face the risk of bank insolvency, but also the risk to be bailed-in by the resolution authority, according to the non-strictly quantitative trigger events of Article 32. Thus, the predictable outcome is to overestimate the risk, asking for an abnormally high yield and subsequently reducing the scope of subordinated bond market, as the Italian case depicted in Section § 3 suggests.

To make the investment in subordinated bonds feasible for both banks and investors, this Section proposes a contractual solution setting a trigger event to convert or write-down the creditors' claim, tailored upon the model offered by "Contingent Convertible" bonds. In fact, subordinated bonds seem to be pretty attractive for both investors and several banks; moreover, they turn to be important even from the resolution authority's standpoint,[83] to protect senior creditor from bail-in and, hence, safeguarding some degree of trust within the banking system.

While the issue of certainty in subordinated bond investments is still without an answer, two recent proposals for amending B.R.R.D. could somehow change the role of subordinated debt as a cushion of senior creditors. In fact, the European Commission issued two proposals of Directive amending the B.R.R.D. in order to implement T.L.A.C. requirements.[84] What is of interests for

[82] Conlon & Cotter, *supra* note 24; *See also* Paolo Santella et al., *Il Nuovo Regime Europeo Di Risoluzione Delle Crisi Bancarie: Un'Analisi Comparata Dell'Applicazione Del Bail-In [A Comparative Analysis of the Bail-In Regime in Europe]*, 9 BANCARIA 46-62 (2015).
[83] Davies, *supra* note 13, at 512.
[84] Commission Proposal for a DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL Amending Directive 2014/59/EU on Loss-Absorbing and Recapitalisation Capacity of Credit Institutions and Investment Firms and Amending Directive 98/26/EC, Directive 2002/47/EC, Directive 2012/30/EU, Directive 2011/35/EU, Directive 2005/56/EC, Directive 2004/25/EC and Directive 2007/36/EC, COM (2016) 852 final (Nov. 23, 2016); and Commission Proposal for a DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on Amending Directive

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the present paper is the proposal to establish an intermediate class of bail-inable liabilities which lies in between subordinated and senior debt, as of hierarchy of creditors' claim. The "new class" of creditors could be written down only during a formal resolution intervention and not with a plain on-going write-down. The purpose of the proposal is helping banking institutions to match the T.L.A.C. requirement at a reasonable price, protecting senior creditor creditors even further.

On the one hand, those proposed amendments are consistent with – and even confirm –the main idea carried out in this paper, i.e.*:* de jure condito, subordinated liabilities act as a cushion for protecting senior creditors. On the other hand, as noticed above, the main problem that has been identified in the paper (i.e.: uncertainty) is not solved, but just shifted and pooled between two different classes. Thus, the prospective implementation of those proposals will not falsify the arguments of this study, which should just be accordingly re-shaped.

For those reasons, the analysis that follows is carried out de jure condito, i.e.: without taking into consideration the possible changes if the latter proposal will be implemented

The following sub-section provides an introduction to the idea of contractual bail-in in the literature and the current institutional framework; eventually, that same framework will be compared with the conditions under which a contractual arrangement is a value-creating institution in the classic law and economics sense.[85]

5.1 CONTRACTUAL CLAUSE FOR WRITING DOWN AND CONVERSION: A PROBLEM SOLVING TOOL

Literature about contractual clauses to convert debt into equity, and thus enhance capital stability and bank resilience, is extensive and precede the global financial crisis,[86] even if the concrete applications are few and

2014/59/EU of the European Parliament and of the Council as Regards the Ranking of Unsecured Debt Instruments in Insolvency Hierarchy, COM (2016) 853 final (Nov. 23, 2016).

[85] *See* ROBERT COOTER & THOMAS ULEN, LAW AND ECONOMICS 283 (6th ed., 2011).

[86] *See* Mark J. Flannery, *No Pain, No Gain? Effecting Market Discipline via "Reverse Convertible Debentures", in* CAPITAL ADEQUACY BEYOND BASEL: BANKING, SECURITIES, AND INSURANCE 171 (2005).

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ambiguous in their results.[87] This mechanism is usually labeled as "Contingent Capital Instruments" or "CoCo Bonds". A major distinction is drawn between high-trigger and low-trigger instruments, where the event that triggers the conversion for the former is to reach the minimum capital requirement, while for the latter the trigger point is set to a higher level of capital ratio.

Coffee[88] approaches contingent capital as a tool to avoid the necessity to bail-out banks and, at the same time, to preserve the financial stability of the banking system, which – in his view – would be threatened by a pure bail-in scenario. Thus, the mandatory contingent capital regime is seen as a substitute and not as a complement of the bail-in mechanism.

Even though this approach is far from the position of the present paper, some aspects underlined by Coffee are of utmost interest. High-trigger contingent capital instruments allow banks to create adequate "potential" capital buffers, increase the level of certainty of investments and have a tax advantage over the "raise more equity" option.

In contrast with the latter approach, Tucker incisively noticed: "Today, Cocos with decently high triggers are likely to be prohibitively expensive . . . . Eventually, I can conceive that Cocos with highish triggers might be issued as a means for the market to maintain control of its own destiny in the shadow of resolution".[89]

This scenario acquired a new and broader meaning with the entrance into force of the post-crisis resolution frameworks. The issuance of Cocos must happen "in the shadow of resolution", which means that the contingent capital instruments are – by definition – a complement and not a substitute of bail-in mechanism, so the Coffee's model is entirely overturned, at least in the Eurozone.

The B.R.R.D. provides two foremost normative references to the role of contractual clauses in the bail-in process. Article 55 deals with the typical case where the bonds are issued under a non-E.U. applicable law (e.g.: bonds issued

[87] *See* Carolin E. Schmidt, Ted F. Azarmi, *The Impact Of CoCo Bonds On Bank Value And Perceived Default Risk: Insights And Evidence From Their Pioneering Use In Europe*, 31 J. APPLIED BUS. RES. 2297 (2015).
[88] *COFFEE, John. Bail-ins versus bail-outs: using contingent capital to mitigate systemic risk. Columbia Law and Economics Working Paper, 2010, 380.*
[89] Tucker, *supra* note 23, at 8.

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under the New York State law are quite common), asking for a contractual recognition of the power of conversion and write-down. This aspect is crucial to make bail-in effective since one of the biggest problems in previous resolution attempts were exactly the cross-border issues.[90]

Even more interesting for this paper is Article 45 (13) and (14) about M.R.E.L.[91]: this can be reached issuing debt instruments with contractual clause for conversion and write-down, following two conditions:

-The Resolution Authority is free to write down or convert the contractual instrument in case of resolution;

-The contractual clause is applied to a subordinated debt instrument.

So, the B.R.R.D. only keeps the possibility of contractual bail-in open, on the contrary of the Swiss Regulator which impose a mandatory 3% R.W.A. of high-trigger Cocos[92].

Davies[93] noticed how such a clause would reverse the hierarchy in bearing losses, meaning that subordinated creditors bear losses before shareholders. This contingency seems to contrast with all the three principals of creditor treatment stated by Article 34 B.R.R.D., confirming again that it provides only disposable rights which generate ex post legal remedies (i.e.: liability and not property rules).

5.2 INCENTIVE STRUCTURE OF RELEVANT ACTORS

Given all the background information of § 5.1, the last question has still to be answered: "Is the institutional framework depicted in the previous paragraph giving adequate incentives to all the relevant actors?". In order to properly answer, the relevant variables discussed in this section are four: the incentives of the management, the role of resolution authority, the desirability of ex-ante

[90] Gleeson, *supra* note 9, at 274.
[91] *See* European Banking Authority, Interim report on MREL, EBA-Op-2016-12, at 76 (Jul. 19, 2016).
[92] Stefan Avdjiev, Anastasia V. Kartasheva & Bilyana Bogdanova, *CoCos: a primer*, BANK INT'L SETTLEMENT QUARTERLY REV., Sept. 2013, at 43. *See* AVDJIEV, Stefan; KARTASHEVA, Anastasia V.; BOGDANOVA, Bilyana. *CoCos: a primer*. Available at SSRN 2326334, 2013.
[93] Davies, *supra* note 13, at 511.

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rights (i.e.: governance power) to bondholders; the trigger event and conversion formula.

1) Management: the fundamental aspect to be analyzed is whether the issuance of subordinated debt with contractual bail-in clause incentivizes the incumbent management to assume opportunistic behaviors or excessive risk taking.

For what concerns opportunistic behavior, the underlying assumption is that – in a non-strategic environment – the decision to issue subordinated debt is a function of the resolution authority conduct. Even though this assumption does not fully hold in the real world, for this analysis it represents a workable proxy.

Article 28 B.R.R.D. provides the possibility to remove the incumbent management "where there is a significant deterioration in the financial situation", while Article 34 § 1 (c) set as a general principle of each resolution intervention the dismissal of the incumbent board. In case of contractual conversion/write-down, the application of Article 34 is highly unlikely, so that the contractual write-down instruments act as a costly insurance paid by the bank to avoid a proper resolution intervention, hence their dismissal. To avoid such a risk, the threat set by Article 28 has to be credible, since the contractual conversion/write-down, even if it is not a proper resolution intervention, is still a "resolution-sensitive" occurrence.

For what concerns excessive risk taking, the arguments stated above can be replicated. Moreover, as the empirical evidenced in § 4 showed, the issuance of subordinated bonds is correlated both with higher loan-to-asset-ratio and lower N.L.P.-ratio. In a hypothetical scenario where the certainty about the subordinated bonds is enhanced, there is no reason to suspect that those evidence would be reversed.

In a nutshell, the formal institutional framework theoretically allows giving suitable incentive to the management if and only if the enforcement mechanism works efficiently.

2) Resolution Authority: the role of the Resolution Authority is perhaps the most important one. From this perspective the formal institutions seem to

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be severely lacking, since the only direct provision on contractual clauses is Article 45 (13) and (14), where is stated the abstract possibility to issue those instruments to reach the M.R.E.L.. The bank and the investor enter into a contract and, at the same time, a third party (the Resolution Authority) might affect a great deal the situation that the contract aims to discipline. In this situation, there is no or very little room for a cooperative solution (*i.e.*: conclude the deal) since the payoff matrix is highly unpredictable.

A possible settlement for this problem is to make the Resolution Authority enter somehow into the agreement. The easiest and cheapest way to do so would be to submit the issuance contract to the resolution authority and ask for its formal inclusion in the resolution plan,[94] stating that the terms of the contract are consistent with a sound resolution planning and, thus, will be respected by the Authority in case of future interventions. This solution would also help to ex-ante mitigate the risk of strategic issuance of the management since the Resolution Authority shall control the consistency of the issuance with the safe and soundness of the banking institution in an on-going concern.

3) Investors: as noted above, because of the contractual bail-in clause, the investors give up some of the rights provided by the Article 34 of the Directive. Thus, granting some ex-ante "property" protection could seem reasonable.[95] A pragmatic approach suggests avoiding the creation of well-design but too complicated and ineffective mechanisms to let subordinated creditors protect *ex-ante* their entitlement. In fact, the effectiveness of the shareholder's empowerment rights is ambiguous, and the possibility to enhance the corporate governance in the case of subordinated bondholders is limited. Therefore, the transaction costs generated by introducing those rights are particularly likely to outweigh some, uncertain and unpredictable, benefits.[96]

[94] For what concerns the crucial role of resolution planning, which was not possible to properly describe throughout this paper, see Binder, 2015.
[95] For example including in the contract some powers modeled on the rights granted to shareholders to empower their position vis-à-vis the board. On shareholder's empowerment, see Van Der Elst, 2014:30-33 and Denes et al., 2016.
[96] Those arguments hold for what specifically concerns the case for contingent convertible holder. A completely different scenario can be depicted in general for the need of corporate governance rights to bail-inalble creditors after B.R.R.D. On those issue see extensively Mülbert, P. O., & Citlau, R. D. (2011). The uncertain role of banks' corporate governance in systemic risk regulation. ECGI–Law Working Paper, (179) Chiu, I. H. (2014). Corporate governance: the missing

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Even though giving specific substantive rights turn out to be ineffective and too expensive, this does not mean that there is absolutely no room for some recognition of the "contractual bail-in bondholder" status, at least from a procedural perspective. In fact, this type of investors should be recognized as an independent class, expressively allowing them to act collectively. This represents a value-creating device since it gives more contractual power to the investors, which will be incentivized to enter into the contract because of decreasing transaction costs, at least in two contingencies:

i) before and regardless any resolution intervention, in case of renegotiation of the contract (savings in bargaining costs);

ii) after a resolution in suing the bank to obtain a compensation (savings in enforcement costs).

From this point of view, the European institutional framework seems to be completely lacking. In fact, a uniform procedural rule for civil justice are far to be reached within the European Union nor specific rules concerning these issues are provided by the Directive. Thus, the concrete configuration of the investors' rights and claims is devolved to national laws, undermining the "level playing field" among E.U. countries, which is one of the primary goals of the B.R.R.D..[97]

4) Trigger Event and Conversion Formula: represents the most awkward clause of the contract for convertible subordinated bonds. Indeed, most of the Contingent Capital literature focuses on this instance developing elaborated theoretical models.[98] In this paper is not possible to add any contribution to such a complex and technical dispute. Anyhow. what is of interest here is whether the current institutional framework allows and incentivize to adopt the efficient solution.

The answer seems to be positive since neither the Directive nor the Guideline on the trigger event[99] or conversion rate[100] forbids to agree on a

paradigm in the mandatory bail-in regime for creditors of banks and financial institutions. Journal of Business Law, (8).

[97] *See* Council Directive 2014/59, recital 57, 108, 2014 O.J. (173).

[98] For a survey, see Glasserman, P., and Nouri, B. (2012). Contingent capital with a capital-ratio trigger. Management Science, 58(10), 1816-1833.

[99] European Banking Authority, Final Report, Draft Regulatory Technical Standards on the contractual recognition of write-down and conversion powers under Article 55(3) of Directive

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tailored solution, with the external limit of respecting the bail-in principle stated in Article 34, leaving to the market any further consideration. Nonetheless, to incentivize the investors to enter into those contracts and to give the market appropriate signals, the conversion formula should favor the creditors and burden shareholders.[101] The potential (plausible) negative externalities of some specific kind of trigger event shall be addressed by the regulator in its "intervention", as proposed above, under n. 3.

The signaling effect is of particular importance both for creditors and the market in general. In fact, a conversion of debt into equity means a dilution in shareholders' cash flows, and likely in management's ones as well. Thus, a bank willing to issue those bonds with a decently high trigger and with a creditor-favorable conversion formula signal to the market and the perspective bondholders its soundness.

6. CONCLUSION

Throughout this study has been demonstrated – theoretically and empirically – that, following F.S.B. position, the existence of an active and functioning market for subordinated bonds enhance the soundness and the resolvability of banking institutions, especially of the medium-small ones. In fact, the cost advantage in raising funds of systemically important banks is reduced, and thus level playing field within European banking market is enhanced.

The new regulatory framework for capital requirements and resolution of distressed institutions lead to tremendous changes in the market for subordinated bonds, both in their demand, supply and pricing mechanism. As a consequence, both banks and investors have to internalize all the costs and risks linked with subordinated bond; which is – at least theoretically – particularly desirable to incentivize more efficient decisions on funding decision, to avoid moral hazard and strategic behavior by both banks and

2014/59/EU, EBA/RTS/2015/06, (Jul. 3, 2015).
[100] European Banking Authority, Consultation Paper, Draft Guidelines Concerning the Interrrelationship Between the BRRD sequence of writedown and conversion and CRR/CRD IV, EBA/CP/2014/29, (Oct. 1, 2014).
[101] *COFFEE, supra* note 88, at 35.

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investors and, consequently, to enhance market discipline capacity of the secondary market.

Nevertheless, due to the concrete bank's financial structure and bail-in regulation, the subordinated debt in resolution, and especially if the Authority resorts to the bail-in tool, assumes the peculiar role of a cushion that allows protecting senior creditors from conversions or dilution in their claims. This leads to a high level of uncertainty in the enforcement of the subordination clause, which endangers the functioning of a market for subordinated bond.

On the other hand, the empirical analysis carried out sub § 4 clearly showed the desirability of a well-functioning market for subordinated bonds, especially for its positive correlation with the lower level of N.P.Ls. and the higher level of loans over assets, i.e.: weakening the credit crunch.

In a nutshell, the current institutional framework appears not to be able to give the appropriate incentives to both investors and banks to issue the right amount of subordinated bonds. Therefore, this paper concludes that a plain mandatory conversion and write down of subordinated debt does not achieve an efficient outcome because of the spillover effects that these rules have on subordinated debt market on a dynamic perspective. To fix those spillover effects and maintain all the positive innovation led by bail-in regulation, this paper proposes the adoption of a "contractual bail-in" regime, tailored on the contingent capital model.

Finally, the paper shows the condition under which the "contractual bail-in" solution turns out to be appealing to banks and investors and, at the same time, desirable from the regulator's standpoint, i.e.: the contractual solution enhance the soundness and resolvability of the regulated institutions. Even though all the actors are involved in the analysis, the role of the supervisory and resolution authorities in abstaining to infringe and protecting the property rights allocated by the contract is the first, necessary, condition to reach an efficient outcome and to balance as well as possible all the interests involved.

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7. APPENDIX

Variables list

Rating	From Thomson Reuters. It measures the rating (if available) for each bond. We relied on three different rating agency: Moody's, Fitch and S&P, according to the availability of complete data for the time series. The ratings are encoded to make them comparable, according to the conversion table published in BIS. See http://www.bis.org/bcbs/qis/qisrating.htm. The higher the code assigned, the higher the rating.
Coupon	From Thompson Reuters. This variable can be continue or vary over time depending whether the bond provides for fixed, variable or floating coupon.
Bond Spread	Own calculation. Underlying variables from Thomson Reuters. The spread between the secondary market yield of each bond and the secondary market yield of 10-year Italian governmental bond. The 10-yaer bond is taken as a benchmark since the duration mean of the subordinated bonds is over nine years, so the 10-year bond represents a significant benchmark.
Volume	From Thomson Reuters. The amount in mil € of the issue calculated in the issue date and invariant over time.
Class of Capital	From Thomson Reuters and Pillar 3 documents. Categorical variables which describe the class of regulatory capital to which the bond belongs. The available possibilities are Additional Tier 1; Tier 2; Low Tier 2 for Basel II agreements, now under the Grandfathering clause during the transitory period; not belonging to regulatory capital.

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E.C.B. supervision	From SSM website. Dummy variable describing whether the bank is under the direct supervision of the E.C.B. (in this case the value 1 is assigned). It measures whether the threshold provided by SSM regulation are significant but still say nothing about the impact of E.C.B. supervision since it started only two years ago.
Capital Ratio	From BankScope. The ratio between total regulatory capital and total liabilities.
Tier 1 ratio	From BankScope. Ratio Between Tier 1 Capital and total liabilities
n° companies	From BankScope. Number of financial and non-financial company controlled by the parent bank. It is used as a proxy of the complexity of the banking group.
Return on Average Assets	From BankScope. Measure the profitability of the bank. It is defined as the ratio between income and the average amount of assets.
Return on Average Equity	From BankScope. Measure the profitability of the bank. It is defined as the ratio between income and the average amount of common shares.
Total assets (log)	From BankScope. Total asset accounted on the balance sheet.
N.P.L. ratio	Own calculation. Underlying variables from BankScope. The ratio between substandard loans and total net loans. In building the variables we used "substandard loans" for the sake of pragmatism, since it was the only component of N.P.L. for which data where available throughout all the sample. Anyhow, substandard loans and the other component of N.P.L. are highly correlated; thus this variable is completely

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	reliable.
Loans over assets	From BankScope. Describe the relative amount of loans granted by each bank.
Sub. debt over regulatory capital	From BankScope. Describe the ratio between the amount of issued subordinated debt and total regulatory capital. We use this variable as dependent to investigate the determinants of decision about capital structure for what concerns issuing subordinated debt.
Sub. debt over total liabilities	Own calculation. underlying variables from BankScope. Describe the ratio between the amount of issued subordinated debt and total liabilities on balance sheet We use this variale as dependent to investigate the determiants of decision about financial structure for what concerns issuing subordinated debt.

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Regression Table 1

	Subordinated debt over liabilities				Subordinated debt over regulatory capital			
	1	2	3	4	5	6	7	8
Class of capital	0.105*			0.0780	-0.548***			-0.288***
	(2.01)			(1.85)	(-4.31)			(-4.01)
Ecb supervision	-0.875**			0	0.152			-0.114
	(-3.01)			(.)	(0.45)			(-0.68)
Capital ratio	0.318***			0.204***	0.0246			0.0741
	(14.58)			(4.19)	(0.50)			(1.95)
Tier1 ratio	-0.318***			-0.235***	-0.00126*			0.000485
	(-12.60)			(-3.75)	(-2.05)			(1.76)
Rating		-0.00524		-0.00476		-0.338		-0.568
		(-0.37)		(-0.40)		(-0.67)		(-1.82)
Coupon		0.0842*		0.00000912		-5.370*		0
		(2.51)		(0.00)		(-2.25)		(.)
Bond spread		-0.00103		0.00409		2.649***		2.517***
		(-0.17)		(1.06)		(13.83)		(8.04)
Volume		-0.000000504		0.000158**		-2.517***		-2.749***
		(-0.01)		(2.70)		(-14.05)		(-6.59)
N° companies			0.0000180	-0.0000653			0.000541	-0.0000662
			(0.27)	(-0.66)			(1.18)	(-0.11)
ROAA			0.348***	0.249***			5.197***	4.778***
			(5.92)	(3.85)			(8.66)	(9.58)
ROAE			-0.0206***	-0.0105**			-0.441***	-0.362***
			(-7.22)	(-2.59)			(-15.98)	(-12.66)
Total assets (log)			-0.0798	-0.126			-1.399***	-1.680*
			(-1.36)	(-1.31)			(-3.35)	(-2.52)
NPLratio			0.00112	-0.00810*			0.0295	-0.0233
			(0.57)	(-2.40)			(1.64)	(-0.65)
Loans over assets			0.0282***	0.0258***			-0.161***	-0.170***
			(4.69)	(4.08)			(-3.72)	(-3.34)
N	621	273	621	273	273	621	621	273
adj. R-sq								
within				0,3758				0,5516
between				0,6023				0,8621
overall				0,4982				0,7545

t statistics in parentheses
* p<0.05, ** p<0.01, *** p<0.001

Regression table on financial structure and regulatory capital structure decision and subordinated debt. Regressions are run with the random effect estimation method and robust error to avoid heteroskedasticity; t-statistic in parenthesis. *, ** and *** denote statistical significance at the 5%, 1% and 0,1% levels, respectively

The same independent variables are used to explain two different dependent variables which aim to describe the two distinct aspects above-

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mentioned, respectively: 'subordinated debt over total liabilities' and 'subordinated debt over regulatory capital' according to the models in equations (1) and (2):

(1) $\text{SubDebt/TotLiabilities} = a_0 + a_1 \sum V^{Bank}_{i,t} + a_2 \sum V^{Bond}_{i,t} + a_3 \sum V^{Regulation}_{i,t} + \varepsilon_{i,t}$;

(2) $\text{SubDebt/RegCapital} = a_0 + a_1 \sum V^{Bank}_{i,t} + a_2 \sum V^{Bond}_{i,t} + a_3 \sum V^{Regulation}_{i,t} + \varepsilon_{i,t}$;

where V^{Bank} are the variables characterizing the issuing bank (number of companies belonging to the group; Return on Average Assets; Return on Average Equity; Total Assets; Non-Performing Loans ratio; Loans over assets ratio); V^{Bond} are the variables characterizing the individual bond issued (Coupon; Volume; Rating; Bond Spread), and $V^{Regulation}$ are variables related to regulatory constraints on banking activity (dummy for class of capital; direct E.C.B. supervision; regulatory capital ratio; Tier 1 capital ratio).

The regressions are run both separately for each category of variable and, eventually, with all the variables together.

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Regression Table 2

	Subordinated debt over total liabilities	Subordinated debt over regulatory capital
	1	2
2006	0	0
	(.)	(.)
2007	0.203	-0.601
	(0.156)	-1.528
2008	0.368***	1.251*
	(0.0317)	(0.583)
2009	0.355***	-1.107*
	(0.0656)	(0.560)
2010	0.209***	-1.066
	(0.0621)	(0.585)
2011	0.0182	0.856*
	(0.0358)	(0.366)
2012	-0.0780	-0.156
	(0.0513)	(0.543)
2013	0.0302	2.134***
	(0.0446)	(0.554)
2014	0.146**	3.312***
	(0.0534)	(0.715)
2015	-0.0273	0.199
	(0.0557)	(0.444)
N	621	621
adj. R-sq		
within	0,0984	0,1097
between	0,0561	0,0152
overall	0,0565	0,0523

Regression table on financial structure and regulatory capital structure decision over time. Regressions are run with the fixed effect estimation method and robust error to avoid heteroskedasticity; t-statistic in parenthesis. *, ** and *** denote statistical significance at the 5%, 1% and 0,1% levels, respectively.

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This issue is addressed as shown in equations (3) and (4), utilizes a time dummy variable to observe whether there has been some significant variation as a result of the introduction of new regulations or economic shocks.

(3) $\text{SubDebt/TotLiabilities} = a_0 + a_1 \sum D^{time} + \varepsilon_{i,t}$;

(4) $\text{SubDebt/RegCapital} = a_0 + a_1 \sum D^{time} + \varepsilon_{i,t}$;

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Regression Table 3

	Bond Spread	Yield
	1	2
Rating	-0.241	-0.241
	(-1.79)	(-1.79)
Class of capital	1.509***	1.509***
	(5.01)	(5.01)
Volume	-0.00105*	-0.00105*
	(-2.11)	(-2.11)
NPLratio	0.115	0.115
	(1.40)	(1.40)
ROAA	-2.590***	-2.590***
	(-3.68)	(-3.68)
ROAE	0.0740**	0.0740**
	(2.77)	(2.77)
Total Assets (log)	-0.539	-0.539
	(-0.93)	(-0.93)
2006	0	0
	(.)	(.)
2007	1.498	1.638*
	(1.80)	(1.97)
2008	5.716**	5.676**
	(3.14)	(3.11)
2009	4.964	4.684
	(1.37)	(1.29)
2010	5.149	5.569
	(1.40)	(1.52)
2011	4.560	7.140*
	(1.29)	(2.01)
2012	7.684	7.794
	(1.31)	(1.33)
2013	2.826	2.506
	(0.56)	(0.50)
2014	4.483	1.953
	(0.85)	(0.37)
2015	6.094	3.274
	(1.14)	(0.61)
N	273	273
within	0,0998	0,0986
between	0,1675	0,1672
overall	0,1268	0,1257

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Regression table on investors' decisions on buying banks subordinated bonds. Regressions are run with the fixed effect estimation method and robust error to avoid heteroskedasticity; t-statistic in parenthesis. *, ** and *** denote statistical significance at the 5%, 1% and 0,1% levels, respectively.

The investors decision are analyzed through equations (5) and (6):

(5) $Yield = a_0 + a_1 \sum V^{Bank}_{i,t} + a_2 \sum V^{Bond}_{i,t} + a_3 Rating_{i,t} + a_4 \sum D^{time} + \varepsilon_{i,t}$;

(6) $BondSpread = a_0 + a_1 \sum V^{Bank}_{i,t} + a_2 \sum V^{Bond}_{i,t} + a_3 \sum V^{Regulation}_{i,t} + a_4 \sum D^{time} + \varepsilon_{i,t}$;

where, where V^{Bank} are the variables characterizing the issuing bank (Return on Average Assets; Return on Average Equity; Total Assets); V^{Bond} are the variables characterizing the individual bond issued (Volume; Rating) and D^{time} is a dummy variable for the time series.

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An Overview of Money Laundering in Pakistan and Worldwide: Causes, Methods, and Socioeconomic Effects

WASEEM AHMAD QURESHI[†]

TABLE OF CONTENTS: 1. Introduction; 2. Causes, Methods, and Effects of Money Laundering; 2.1. Causes of Money Laundering; 2.1.1. Tax Evasion; 2.1.2. Weak Financial Regulations; 2.1.3. Bribery; 2.1.4. Corruption; 2.1.5. Failure of Banks in Detecting Laundered Money; 2.1.6. Nature of Borders; 2.2. The Three Stages of Money Laundering; 2.2.1. Placement; 2.2.2. Layering; 2.2.3. Integration; 2.3. The Methods of Money Laundering; 2.3.1. Structuring of Money; 2.3.2. Smuggling; 2.3.3. Laundering through Trade; 2.3.4. N.G.Os.; 2.3.5. Round Tripping; 2.3.6. Bank Control; 2.3.7. Cash-Oriented Businesses; 2.3.8. Money Laundering through Real Estate; 2.3.9. Foreign Exchange; 2.4. Effects of Money Laundering; 2.4.1. Economic Impacts; 2.4.2. Social Impacts; 3. Global Magnitude and Combating of Money Laundering; 3.1. Magnitude of the Problem; 3.2. Curbing Money Laundering; 3.2.1. International A.M.L. Organizations; 3.2.1.1. Financial Action Task Force (F.A.T.F.); 3.2.1.2. United Nations Office on Drugs and Crime; 3.2.1.3. FinTRACA; 3.2.2. International A.M.L. Standards; 3.2.2.1. United Nations Convention against Illicit Traffic in Narcotic Drugs and Psychotropic Substances; 3.2.2.2. United Nations Convention against Transnational Organized Crime; 3.2.2.3. United Nations Convention against Corruption; 3.2.2.4. F.A.T.F. Recommendations; 3.2.3. Criticisms of A.M.L. Standards; 3.3. Notable International Money Laundering Cases; 3.4. A.M.L. Legislation in Different Countries; 3.4.1. The U.S.; 3.4.1.1. Preventive Money Laundering Measures; 3.4.1.2. Criminal Offenses Measures; 3.4.1.3. Impacts of A.M.L. Legislation; 3.4.2. The U.K.; 4. Money Laundering and Pakistan; 4.1. Channels of Money Laundering; 4.1.1. Drug Trafficking; 4.1.2. Smuggling of Cash; 4.1.3. Corrupt Politicians and Administrators; 4.1.4. Real Estate Business; 4.1.5. Tax Evasion; 4.1.6. Hundi; 4.2. Terrorism Financing; 4.3. Pakistan and International A.M.L. Standards and Organizations; 4.4. Prominent Cases of Money Laundering in Pakistan; 4.4.1. The Case of the Khanani and Kalia Foreign Exchange Company; 4.4.2. The Cash Smuggling Case of Ayyan Ali; 4.5. A.M.L. Legislation in Pakistan; 4.6. Effects of A.M.L. Legislation in Pakistan; 5. Conclusion.

ABSTRACT: Money laundering is the clandestine movement of cash from one region to another without notifying it to the government authorities with the purpose of evading taxes, disguising ill-gotten incomes, and converting illegally earned money into legitimate assets. Money laundering involves three steps: the placement of cash into a foreign bank, performing transactions as layers of cash, and then capitalizing the withdrawn cash into legitimate investments. The failure of financial institutions, including banks, in detecting the laundered cash is a major reason for money laundering. On the other hand, round tripping, cash structuring, bank controlling, N.G.O. funding, and foreign exchange agencies' illegal money transferring activities are some of the methods of performing money laundering, which in the long run cause disastrous effects to the economy, especially on the private sector and emerging

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markets. Money laundering also invites social costs, which expedite the elevation of other serious crimes such as drug trafficking, smuggling, arms trafficking, and the financing of terrorism. Through effective legislation and implementation of anti-money laundering laws, as well as cooperating with international anti-money laundering agencies, the illicit crime of money laundering can be prevented at both regional and global levels.

KEYWORDS: *Money Laundering; Anti-Money Laundering (A.M.L.); Drug Trafficking; Smuggling; Stages of Money Laundering; Round Tripping; Terrorism Financing; Tax Evasion.*

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1. INTRODUCTION

Money laundering is the method used for transferring money earned through clandestine means[1] to or from a foreign land without paying the tax applicable on the transferred amount.[2] It can also be defined as converting illicit monetary assets into legitimate possessions.[3] Money laundering is recognized as a crime in domestic law worldwide. It is also considered a thought crime.[4] The United States Treasury Department has defined money laundering as disguising financial transactions and funds that are used by terrorists or other criminals for their illicit purposes.[5] Money laundering can be carried out through several kinds of financial and commercial activities, for instance digital money transfers, cash transactions, credit card payments, offshore property building, and wire transfers, Money laundering can be carried out through several kinds of financial and commercial activities, which include supposedly legal actions such as digital money transfers, cash transactions, credit card payments, offshore property building and wire transfers.[6] Money is also laundered through trading, drug trafficking, smuggling, etc., thus allowing Anti-Money Laundry (hereinafter A.M.L.) international financial and legal authorities to describe money laundering as an illegal activity[7] that is intertwined with other serious crimes.[8] Notably, the financing of terrorist and other criminal organizations is also conducted through the channels of money laundering.[9]

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[1] *See* JOHN MADINGER, MONEY LAUNDERING: A GUIDE FOR CRIMINAL INVESTIGATORS 5 (3rd ed, CRC Press 2016) (1999) [Hereinafter: Madinger].

[2] *See* PAUL V. DALY, THE SUPPLY OF ILLICIT DRUGS TO THE UNITED STATES: THE NNICC REPORT 78 (1996).

[3] *See* COLLEEN CROSS, EXIT STRATEGY (Slice Publishing 2014) (2011).

[4] *See* MARK NESTMANN, THE LIFEBOAT STRATEGY (eBookIt.com 2011) (2003).

[5] *See* JAMES R. RICHARDS, TRANSNATIONAL CRIMINAL ORGANIZATIONS, CYBERCRIME, AND MONEY LAUNDERING 44 (1999).

[6] *See* IMF, Staff Country Reports, 19 (2009).

[7] *See* ASIAN DEVELOPMENT BANK, *Manual on Countering Money Laundering and the Financing of Terrorism,* ADB.ORG (Mar., 2003), https://www.adb.org/sites/default/files/publication/27932/countering-money-laundering.pdf.

[8] *See* BRIGITTE UNGER & DAAN VAN DER LINDE, RESEARCH HANDBOOK ON MONEY LAUNDERING (2013).

[9] *Id.*

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There are various ways to launder money, each method having a certain level of complexity associated with it.[10] Nonetheless, money launderers almost always perform the following interlinked three steps: 1) placement, or structuring, of funds; 2) layering; and 3) integration.[11] The only exceptions include cases that involve non-cash funds that might already be present in the fiscal system.[12]

The methods and magnitude of money laundering, and its causes and effects, in different countries, including Pakistan, the United Kingdom (U.K.), and the United States (U.S.), will be elaborated in this paper, along with the measures for preventing the crime, regionally as well as internationally.

2. CAUSES, METHODS, AND EFFECTS OF MONEY LAUNDERING

2.1. CAUSES OF MONEY LAUNDERING

Several factors give rise to money laundering, and they may be present within a country or state, or might operate transnationally.[13] Some of the most prominent factors that lead to money laundering are discussed below.

2.1.1. TAX EVASION

Tax evasion leads to the hiding of financial assets owned by a person or company—to evade taxes, people hide their assets and the sources of their earnings[14] Generally, the rationale behind avoiding paying taxes is accumulating wealth. Moreover, some people do not give a portion of their wealth to the government, particularly if they feel that their tax money would not benefit their well-being or if they have no concern for the public good.[15]

[10] *See* ERNESTO U. SAVONA, EUROPEAN MONEY TRAILS 15 (Routledge 2014) (1999).
[11] *See* JEROME BJELOPERA & KRISTIN FINKLEA, ORGANIZED CRIME: AN EVOLVING CHALLENGE FOR U.S. LAW ENFORCEMENT 14 (2012).
[12] *See* U.S. GOV'T ACCOUNTABILITY OFF., GAO-03-813, COMBATING MONEY LAUNDERING OPPORTUNITIES EXIST TO IMPROVE THE NATIONAL STRATEGY 7 (2003).
[13] *See* KANNAN SUBRAMANIAN, THE MONEY LAUNDERING AND FINANCING OF TERRORISM ECO-SYSTEM (2016).
[14] *See* Richard Waber, *Money Laundering*, U.S ATT'Y BULL., Sept. 2007, at 21.
[15] *See* LAWRENCE GITMAN, MICHAEL JOEHNK & RANDY BILLINGSLEY, PERSONAL FINANCIAL PLANNING 82 (3RD

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Tax evaders might also perform manipulations of their tax forms by not reporting the correct amount of income that they get from different sources. Upon fearing that the authorities might track their concealed monetary and nonmonetary assets and earnings, they either transfer their money to foreign banks, or invest in property ventures furtively by hiding their identities and reassigning ownership of their nonmonetary assets and property into someone else's name, usually that of a family member without the will or capacity to control that asset independently.[16] This constitutes tax evasion if the transferred property is not shown on income tax returns[17] and can lead to money laundering if the cash or property is transferred to foreigners' accounts surreptitiously. This type of laundering is also performed by politicians, especially those who are in or seeking power. They hide their monetary and nonmonetary wealth assets[18] or transfer them to foreign lands to avoid scrutiny by tax authorities.[19] Hence, this crime is performed by the "will" of politically powerful elites, whose influence surpasses the authority of A.M.L. authorities and, thus, the practice continues until they lose their political influence or power.[20]

2.1.2. WEAK FINANCIAL REGULATIONS

Another cause of money laundering is the weakness and inadequacy of financial regulations and relevant authorities within a country. For instance, if the tax department is not strong enough to question the politicians, elites, and general public about their earnings and "monetary and nonmonetary" assets, then it is not difficult for people to hide taxes and perform money laundering by buying property in relatively more stable but offshore economies.[21]

Money laundering and tax evasion are crimes which need to be curbed by the financial regulatory authorities and institutions. The financial

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ED. 2014).

[16] *See* MARK GOODFIELD, *Transferring Property among Family Members*, LINKEDIN (Sept. 23, 2014), https://www.linkedin.com/pulse/20140923125602-8635921-transferring-property-among-family-members-a-potential-income-tax-nightmare.

[17] *See* ERNEST LARKINGS, INTERNATIONAL APPLICATIONS OF U.S. INCOME TAX LAW 380 (2003).

[18] *See* ATO KWAMENA ONOMA, THE POLITICS OF PROPERTY RIGHTS INSTITUTIONS IN AFRICA 219 (2009).

[19] *See* JOHN CASSARA, TRADE-BASED MONEY LAUNDERING 79 (2015) [Hereinafter: Cassara].

[20] MADINGER, *supra* note 1, at 3.

[21] *See* MARY ALICE YOUNG, BANKING SECRECY AND OFFSHORE FINANCIAL CENTERS 12 (2013).

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regulatory authorities in each country need to re-examine their policies and financial regulatory principles to check if they can be implemented effectively or if there are any loopholes that might allow politicians and the elite classes to conceal the details and sources of their assets, as well as destinations of money that they receive or transfer to foreign regions at any given time.

2.1.3. BRIBERY

Bribery is also linked to weak financial regulations as financial regulatory authorities or airport officials might be bribed by money launderers to allow them to transfer funds abroad without paying the applicable taxes and by not tracking down the sources or destinations of the money.[22] This paves the way for secured money laundering facilitated by the officials of airport authorities.[23] As a consequence, the money illegally moves out of the country.

2.1.4. CORRUPTION

Corruption is unethical conduct aimed at gaining personal benefits by using either authority or bribery.[24] Politicians, statesmen, ministers, etc. hide the monetary and nonmonetary assets that they earn illegitimately, i.e., through means of corruption. For instance, they might take bribes and would prefer to transfer the bribe money into foreign banks or other investments.[25] They would thus avoid transferring it to local or personal bank accounts so that local financial auditing authorities do not discover the bribe amount.[26] Hence, their corruption causes a flow of cash to foreign banks or causes them to hide their financial assets as well as the sources of earning, which leads to money laundering. It is of paramount importance we curb corruption in order to prevent this form of crime

[22] *See* IAN JEFFRIES, THE NEW RUSSIA: A HANDBOOK OF ECONOMIC AND POLITICAL DEVELOPMENT 88 (2002).
[23] *Id.*
[24] *See* COMMONWEALTH SECRETARIAT, COMBATING MONEY LAUNDERING AND TERRORISM FINANCING 66 (2006).
[25] *See* MARGARET E. BEARE, ENCYCLOPEDIA OF TRANSNATIONAL CRIME AND JUSTICE 37 (2012) [Hereinafter: Beare].
[26] *Id.*

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2.1.5. FAILURE OF BANKS IN DETECTING LAUNDERED MONEY

Another reason for the untracked facilitation of money laundering is the failure of banks to detect and report the money in their reserves that is being laundered.[27] Huge sums of money are transferred by money launderers to foreign banks, and some accept without carrying out any effective inspection as to their source.[28]

Unfortunately, there is no automated mechanism devised worldwide to accurately track down the source of money; neither do most banks usually pay any attention to it because of the costs associated with it[29]. Furthermore, there is no incentive to use resources to investigate the money that has been placed in their financial reserves.[30] Therefore, the issue remains untouched and unrestrained, and causes banks not to perform sufficient scrutiny over the funds that reach their branches through wire transfers or any other means, which consequently encourages money launderers to transfer funds to foreign banks without any threat of being accountable for the actual source of the money.[31] For example, in 2010 H.S.B.C. was convicted of being involved in money laundering as it did not scrutinize the movement of laundered cash that its different branches worldwide were receiving and transacting.[32] Consequently, the bank was fined $1.9 billion by the international financial regulatory and A.M.L. authorities.[33]

2.1.6. NATURE OF BORDERS

Online financial transactions and the smuggling of cash through airports are not the only means of laundering money. Cash is also smuggled physically through borders, particularly in those countries where there is weak or no

[27] *See* 1 LAWRENCE SALINGER, ENCYCLOPEDIA OF WHITE-COLLAR & CORPORATE CRIME 78 (2005).
[28] *Id. See also* U.S. Dep't of State, *The Fight against Money Laundering,* ECON. PERSPECTIVES, May 2001, at 27.
[29] *See* STEVEN MARK LEVY, FEDERAL MONEY LAUNDERING REGULATION: BANKING, CORPORATE AND SECURITIES COMPLIANCE 1–17 (2nd ed. 2016).
[30] *See* MICHAEL TONRY, THE OXFORD HANDBOOK OF CRIME AND PUBLIC POLICY 375 (2009).
[31] *Id.*
[32] *See* FERNANDO SOTELINO & IRENE FINEL-HONIGMAN, INTERNATIONAL BANKING FOR A NEW CENTURY 202 (2015).
[33] *Id.*

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vigilance over cross-border trafficking.[34] For instance, this practice is more common across the international borders of countries where the border area is either mountainous or too long to control and monitor strictly and continuously, e.g., across the Mexico–U.S. border[35] or the Afghanistan–Pakistan border.[36] [37] The money launderers, in such a case, act as smugglers and either cross the border themselves or assign the chore to their loyal followers.[38] Drug lords prefer to launder money by smuggling cash in return for drugs and vice versa.[39] This is the quickest and safest mode of money laundering for them as they do not have to create any bank accounts and never have to show their identity during online transactions. They remain undercover and get money through furtive sources of money laundering.[40]

This issue has affected the peace of the countries where the smuggling of cash and weapons is taking place across borders.[41] There have been reported

[34] BEARE, *supra* note 25, at 37.
[35] *Id.*, at 38.
[36] *See* 2 BUREAU FOR INTERNATIONAL NARCOTICS AND LAW ENFORCEMENT, U.S. DEP'T OF STATE, INTERNATIONAL NARCOTICS CONTROL STRATEGY REPORT: MONEY LAUNDERING AND FINANCIAL CRIMES 149 (2011) [Hereinafter: Brownfield].
[37] Both, the Mexico–USA and the Pakistan–Afghanistan borders are spread across mountainous regions and they are very difficult to fully track and continuously monitor by the border security forces. For details, see BEARE, *supra* note 25, at 38. see also *Id.* .
[38] Brownfield, *supra* note 36, at 11.
[39] *See* WILLIAM BLAKE, A MANUAL OF PRIVATE INVESTIGATION TECHNIQUES 222 (2013).
[40] For instance, in Mexico and Afghanistan, smugglers and money launderers smuggle large sums of money as well as large quantities of drugs across international borders, because, here, Mexico and Afghanistan are the leading manufacturers and traffickers of illicit narcotic drugs. The drug dealers and manufacturers in these countries earn money through smuggling drugs to other countries and laundering cash profits in return. The Mexican drug dealers have the aim of smuggling drugs through the U.S. border in order to gain a higher return in U.S. currency by surreptitiously selling drugs there and to launder the earned dollar currency in Mexico. Similarly, the Afghan drugs manufacturers get laundered cash money by trafficking the drugs across the international borders of Afghanistan to the Balkan states, Iran, Central Asian republics, and through Pakistan to the Golden Triangle (Burma–Thailand–Laos), which is the center of drugs trafficking to East Asia, Australia, Canada, and Europe. The border with Pakistan becomes the gateway for Afghan drugs manufacturers for receiving of large sums of cash, which they earn from the Golden Triangle region's traffickers of drugs. Hence, the cash surreptitiously flows in the region in parallel to the clandestine drugs trafficking. For details, see Brownfield, *supra* note 36, at 11-149.
[41] For instance, in certain states of the US, gun permit laws are in effect that legalize the sale and carrying of guns. The drug dealers, money launderers, smugglers, and criminals from Mexico acquire guns from these states and surreptitiously smuggle them to Mexico. In this way, the guns and weapons are being trafficked to Mexico. For details, see JESS T. FORD, FIREARMS TRAFFICKING: U.S. EFFORTS TO COMBAT ARMS TRAFFICKING TO MEXICO FACE PLANNING AND COORDINATION CHALLENGES: CONGRESSIONAL TESTIMONY, 3. (2009) . Arturo Santa Cruz and Brian Bow further elucidate in their book that drugs trafficking organizations (DTOs) earn money by acquiring weapons from U.S. firearms traders and selling the weapons to other criminal organizations in Mexico or in other regions. The money earned by these DTOs is, in fact, black money that they receive through laundering of cash. For details, see BRIAN J. BOW & ARTURO SANTA-CRUZ, THE STATE AND SECURITY IN MEXICO: TRANSFORMATION AND CRISIS IN REGIONAL PERSPECTIVE, 30 (2013).

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cases in which the smuggled currency has been used for illegitimate purposes, i.e., mostly for financing terrorist and anti-state activities in these countries.[42]

2.2. THE THREE STAGES OF MONEY LAUNDERING

Money is laundered in the following three steps.[43]

2.2.1. PLACEMENT

The first step is related to depositing cash funds in foreign banks.[44] This step is called placement, as the funds are placed in foreign banks without drawing the attention of national authorities.[45]

2.2.2. LAYERING

The second step is linked to carrying out financial transactions, cash withdrawals, wire transfers, etc. and hiding the original source of money.[46] This step is called layering, as the money launderer performs several financial transactions, which act as layers of cash.[47] Online transactions, notably wire transfers, are the quickest way of layering,[48] as multiple cash transactions can occur speedily through them.

2.2.3. INTEGRATION

The third step is related to the use of money for investment or any other action. This step is called the integration of funds, as the laundered money is actually used at this stage.[49] When money has reached this step, it becomes

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[42] Beare, *supra* note 25, at 37–40.
[43] *See* ROBERTO DURRIEU, RETHINKING MONEY LAUNDERING & FINANCING OF TERRORISM IN INTERNATIONAL LAW: TOWARDS A NEW GLOBAL LEGAL ORDER, 36–38 (474 ed. 2013).
[44] *See* SUNDER GEE, FRAUD AND FRAUD DETECTION: A DATA ANALYTICS APPROACH 254 (2015); *See also* ENID MUMFORD, DANGEROUS DECISIONS: PROBLEM SOLVING IN TOMORROW'S WORLD 187 (1999).
[45] *Id.*
[46] *See* KAROLINE SPIES & RAFFAELE PETRUZZI, TAX POLICY CHALLENGES IN THE 21ST CENTURY 258 (2014).
[47] *Id.*
[48] *See* JAMES BANKS, ONLINE GAMBLING AND CRIME: CAUSES, CONTROLS AND CONTROVERSIES 71 (2016).
[49] *See* MUMFORD, *supra* note 44.

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difficult or almost impossible for the A.M.L. authorities to track the laundered money, unless a trial or investigation had started when the money was in the first or second stage.[50]

All of the three steps are interconnected and must take place for the laundered money to be used in the foreign land.[51] Nonetheless, if someone transfers large taxable[52] sums of money to the foreign banks and does not withdraw the money there, i.e., if there is a placement of funds but no withdrawal or integration, then this would still be considered money laundering if the funds had been transferred without notifying the local government authorities and, in particular, if the amount had been transferred without paying tax on it.[53]

2.3. THE METHODS OF MONEY LAUNDERING

There are also several methods that smugglers and money launderers use to perform the crime of money laundering without bringing it to the attention of any A.M.L. authorities

2.3.1. STRUCTURING OF MONEY

This method entails the division of large amounts of cash, which need to be laundered, into smaller amounts.[54] Each divided amount is then transferred, through money orders, online transactions, cash deposits, etc., to foreign

[50] *See* 1 ROBERT C. EFFROS, CURRENT LEGAL ISSUES AFFECTING CENTRAL BANKS 240 (1992); *see also* its Volume 2, 1994.
[51] MADINGER, *supra* note 1, at 7.
[52] In every country, national governments have allowed certain amount of cash that can be transferred or moved across international borders for every individual for any purpose. Any cash beyond that certain amount is a taxable amount of money. If the taxable amount of cash is transferred or moved across the international border without notifying the local financial regulatory authority, government, or tax authorities, then this will be considered money laundering. For details, see WORLD BANK (WB), *Combating Money Laundering and the Financing of Terrorism: A Comprehensive Training Guide* (Jun. 25, 2009), http://documents.worldbank.org/curated/en/389491468331905743/pdf/499600v10PUB0C101Official0Use0Only1.pdf. In addition, to read about the taxable amount of a country, see the local laws and financial regulations of that country.
[53] *Id.*
[54] *See* PIERRE-LAURENT CHATAIN, ANDREW ZERZAN, WAMEEK NOOR, NAJAH DANNAOUI & LOUIS DE KOKER, PROTECTING MOBILE MONEY AGAINST FINANCIAL CRIMES: GLOBAL POLICY CHALLENGES AND SOLUTIONS 35 (2011).

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banks. The nontaxable sum,[55] which can be legally traveled with, can also be taken to the foreign country by traveling legitimately. The scheme of dividing a sum of money into smaller portions and transferring the portions is also termed "smurfing."[56] It generally includes the first stage of money laundering—the placement of funds in foreign banks—either through online transfers, wire transfers, money ordering, or traveling as a group but pretending to be individuals, with each person having the maximum but different amount of cash to legally travel with.[57]

2.3.2. SMUGGLING

This method involves taking bulk cash to a foreign country by deceiving the airport or border authorities of the actual amount of money being displaced. This amount is then deposited into a bank of that foreign country, where the money laundering laws might be weaker or not strictly enforced.[58] This is considered to be the most common method of money laundering.[59]

2.3.3. LAUNDERING THROUGH TRADE

Money laundering through trade happens when invoices are either undervalued or overvalued, depending upon the cash inflow/outflow or costs, respectively. Traders often accomplish this by providing fake invoices and accounts.[60]

2.3.4. N.G.OS.

Founding a non governmental organization (hereinafter N.G.O.) and registering it in another country and providing funds to it can lead to money laundering if the N.G.O. is not making use of the funds for a noble cause for the

[55] The maximum amount of cash which it is legal to possess while traveling abroad.
[56] Zerzan et al., *supra* note 54.
[57] *See* PHILIP REICHEL & JAY ALBANESE, HANDBOOK OF TRANSNATIONAL CRIME 170–260 (2014).
[58] Beare, *supra* note 25, at 37.
[59] *See* Act of Mar. 31, 2002, Pub. L. No. 107–156, 2049.
[60] *See* RAYMOND W. BAKER, CAPITALISM'S ACHILLES HEEL: DIRTY MONEY AND HOW TO RENEW THE FREE/MARKET SYSTEM 25 (2005).

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local public.[61] Some businessmen create trust organizations and give their money to them as a charity payment so that the charitable amount is not taxed; this therefore avoids taxation.[62] If such an N.G.O. or trust organization is working in another country and the funds are provided to it in the foreign land illegitimately, then it certainly constitutes money laundering.[63]

On the other hand, ironically, some N.G.Os. have also been reported to be linked with terrorist or anti-state elements, and the funds are generated to such elements through N.G.Os.[64] For instance, in Pakistan, after the attack on the Army Public School children in Peshawar, several N.G.Os. were banned from Pakistan by the Interior Ministry because those N.G.Os. were reportedly involved in anti-state activities and were also diverting their funds to finance terrorism.[65] Similarly, "madrassahs" and educational trust institutes that were receiving laundered money from abroad were also shut down by the Pakistani government.[66]

2.3.5. ROUND TRIPPING

Round tripping is used for money laundering,[67] as well as for tax evasion.[68] This is a technique through which a company sells its assets to another

[61] This aspect was identified by the Bank Secrecy Act of U.S (1970). For details, see FED. FIN. INSTITUTIONS EXAMINATION COUNCIL, BANK SECRECY ACT/ ANTI-MONEY LAUNDERING EXAMINATION MANUAL 311 (2014).

[62] This is a globally accepted principle that nonprofit charity organizations are not taxed in accordance with the laws in every country, generally. For details, see JOSEPH J. CORDES, ROBERT D. EBEL & JANE G. GRAVELLE, THE ENCYCLOPEDIA OF TAXATION & TAX POLICY 277 (2005).

[63] This is because the NGO is not working as a charitable organization as it is not performing any charitable nonprofit activity. It receives large cash flows that are, though taxable, not taxed owing to the charity label associated with that organization. Hence, such an NGO is showing a false appearance of itself, which itself is a crime in addition to the crime of money laundering that is associated with the cash it receives. For details, see MICHAEL BARNETT & JANICE STEIN, SACRED AID: FAITH AND HUMANITARIANISM 152–153 (2012).

[64] *See* EMILY JANSONS, FEMIDA HANDY & MEENAZ KASSAM, PHILANTHROPY IN INDIA: PROMISE TO PRACTICE 40 (2016). *See also* Bank Secrecy Act, *supra* note 61.

[65] For instance, see the statements by the former Interior Minister of Punjab Col. (Retd.) Shuja Khanzada at: IMRAN ALI, *Some NGOs involved in Pakistan terrorism – Shuja Khanzada,* STAYCONNECTING.COM (Apr. 11, 2015), http://stayconnecting.com/some-ngos-involved-in-pakistan-terrorism-shuja-khanzad/; *See also* the statements from the Federal Interior Minister Ch. Nisar Chaudhry at: IRFAN HAIDER, *Pakistan will not allow NGOs working against national interest: Nisar*, DAWN.COM (June 12, 2015), https://www.dawn.com/news/1187773.

[66] DAWN NEWSPAPER STAFF REPORTER, *Terror – linked madressahs to face action: Khanzada*, DAWN.COM (Jan. 16, 2015), http://www.dawn.com/news/1157389.

[67] *See* LINDA M. AMBROSIE, SUN & SEA TOURISM: FANTASY AND FINANCE OF THE ALL-INCLUSIVE INDUSTRY 3 (2015).

[68] *See* ALAN R. KANUK, CAPITAL MARKETS OF INDIA: AN INVESTOR'S GUIDE (2011).

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company and then, at the same time, signs an agreement to buy some or all of the same assets at the same price. The selling and buying of assets liquefies[69] the latter, facilitating their quick conversion into cash and vice versa. The cash can be moved abroad by labeling it as "foreign direct investment" (hereinafter F.D.I.) and is exempted from tax.[70] For instance, an individual or a company might hire a foreign law firm or any other organization and pay it for their services; it then cancels the agreement exactly at the time when the money (fee) has been sent.

2.3.6. BANK CONTROL

In this method, money launderers become major shareholders of a bank in a foreign or local region where there is weak scrutiny related to money laundering. Hence, by making an investment in the bank and gaining some shares, the money launderers try to gain influence over the bank and perform money laundering through it without scrutiny as it becomes a major client of that bank. This kind of money laundering is very rarely identified because the financial regulatory authorities consider the movement of currencies from the bank as usual cash proceeds.[71] Nonetheless, examples of investigating banks for money laundering cases exist in recent history; for instance, H.S.B.C. was fined $1.9 billion after conviction for money laundering.[72]

2.3.7. CASH-ORIENTED BUSINESSES

Some enterprise organizations are involved in cash-oriented businesses, i.e., they deal with large sums of cash and have multiple operations, some of which are also linked to illegal activities, for instance gambling bars, casinos, and clubs. Such businesses do not specifically show their income earned through illegal means, neither do they record the destination of their funds.[73] They

[69] Liquefying the assets implies turning the assets into cash. A liquefied asset can be bought and sold at the same price.
[70] BEARE, *supra* note 25, at 37.
[71] *See* LAWRENCE M. SALINGER, ENCYCLOPEDIA OF WHITE-COLLAR & CORPORATE CRIME 78 (2005).
[72] *See* MERRILL SINGER & BRYAN PAGE, THE SOCIAL VALUE OF DRUG ADDICTS: USES OF THE USELESS 145 (2016).
[73] *See* BANKS, *supra* note 48.

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depict the "dirty money"[74] as clean money that is included in their profit,[75] and this constitutes money laundering. For example, a person enters a casino with huge sums of cash earned through illegal means. He plays the game for a while and gives all the cash to the casino. This cash is represented by casinos as a profit amount earned through gambling wins.[76] However, it is not investigated whether the person who gave the cash to the casino might have originally worked for that casino or for a money launderer who is connected directly to the casino.

2.3.8. MONEY LAUNDERING THROUGH REAL ESTATE

Some criminals buy property with cash earned through illegal means and then sell the property to reacquire the cash, so as to justify it as legitimate money.[77] As the illegitimate money is converted into legitimate earnings, it is considered laundered money.[78] It is also possible that the price of that property may be underrepresented to reduce the taxable amount.[79] This hides the exact amount of money spent on buying the property, and it is mainly done to evade tax.

2.3.9. FOREIGN EXCHANGE

Uncertified and unregulated foreign exchange companies also have a presence in different regions of several countries. These companies also collect

[74] Money earned through illegitimate means.

[75] World Bank, *supra* note 52.

[76] *See* U.S. MONEY LAUNDERING THREAT ASSESSMENT 33 (2005)US DRUG ENFORCEMENT ADMINISTRATION – DEPARTMENT OF JUSTICE,National Money Laundering Threat Assessment, 33 (2005); See also BANKS, *supra* note 48.

[77] This process is also called "whitening of money." The black money earned by the criminals is whitened by deceivingly depicting the earnings as legitimate. For instance, if a person who earns black money and also owns a property, e.g., a restaurant or hotel, then he/she can persuade the tax authorities that the earnings are coming as profits from his/her restaurant or hotel property and are not from any illegal source. In this way, he/she can outwardly present his black money as legitimate. However, for this purpose, the launderer may need to perform or acquire services of a fraudulent audit of his/her money. He can perform this by bribing audit officials to list his black money as white money and earnings from his legitimate sources. For details, see JORIS D. KILA & MARC BALCELLS, CULTURAL PROPERTY CRIME: AN OVERVIEW AND ANALYSIS OF CONTEMPORARY PERSPECTIVES AND TRENDS 80 (2014).

[78] The black money has been converted to white money; however, it will still be considered laundered money because the conversion is illegal and surreptitious. The act of unlawful conversion or the act of hiding the actual source of money directly constitutes money laundering. For details, see VARUN CHANDNA, THE CURIOUS CASE OF BLACK MONEY AND WHITE MONEY: EXPOSING THE DIRTY GAME OF MONEY LAUNDERING! (2017).

[79] *See US CONGRESS, CONGRESSIONAL RECORD, VOLUME 149, PT. 12, 16823 (2003).*

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remittances and then deliver the relevant amount of remittance to the families of the senders without notifying government authorities.[80] These foreign exchange companies have multiple currencies with them and they usually transfer funds abroad upon the requests of the locals. Meanwhile, the government never notices that the foreign exchange companies are transferring funds abroad or are collecting cash that is sent to them from people from foreign lands as remittances. Hence, the government is deprived of the collection of remittances, as well as the taxes that it can get from the cash that is sent abroad. As a result, this method of currency exchange or remittances, which is also related to Hawala[81] or Hundi, is illegal[82] in most countries.[83]

2.4. EFFECTS OF MONEY LAUNDERING

The effects of money laundering are socioeconomic in nature.[84] Money laundering affects the nation's economy, as well as giving rise to several social costs.[85] On the one hand, it spoils the strength of the economy by causing a corrosive impact;[86] on the other hand, it acts as a social evil.[87] Some of the major impacts of money laundering are discussed below.

2.4.1. ECONOMIC IMPACTS

Money laundering reduces the control of government over economic policy. It also raises the risk of the potential failure of banks, businesses, and government to implement economic policies. Furthermore, due to globalization, the impacts reach international monetary systems and can

[80] For instance, read about the remittances coming to Pakistan and whitening of black money flowing from Pakistan at: RASHID AMJAD & SHAHID JAVED BURKI, PAKISTAN: MOVING THE ECONOMY FORWARD 15 (2015).
[81] CASSARA, *supra* note 19, at 61.
[82] *See* DAVID GOLD & SEAN COSTIGAN, TERRORNOMICS 58 (2016).
[83] *See* Mohammed El-Qorchi, *Hawala: Based on Trust, Subject to Abuse*, ECON. PERSP., Sept. 2004, at 23.
[84] SUSANNE ROSNER, MONEY LAUNDERING 4 (2010). *See also* INTER-AMERICAN DEVELOPMENT BANK, UNLOCKING CREDIT: THE QUEST FOR DEEP AND STABLE BANK LENDING, 242 (2004).
[85] *See* John McDowell & Gary Novis, *The Consequences of Money Laundering and Financial Crime*, ECON. PERSP., May 2001, at 8.
[86] *Id.*, at 6.
[87] *Id. See also* DONATO MASCIANDARO, GLOBAL FINANCIAL CRIME: TERRORISM, MONEY LAUNDERING, AND OFF SHORE CENTRES, 63 (2004).

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adversely affect international currencies and economies, depending upon the volume of money laundering.[88]

Vulnerable Emerging Markets

Money laundering also affects emerging markets in those regions where it is established. Emerging markets are more vulnerable to the impact of money laundering because financial regulatory authorities give more attention to well-established and strong markets than to emerging ones.[89]

For instance, cross-border trade can be an emerging market if the relations between the bordering countries have been recently established, as peaceful and agreements of economic cooperation and trade development have been signed. In such a case, if the encouragement of trade is greater than the oversight over trade, then the smugglers, drug lords, and even terrorists will benefit from it by moving their black money, drugs, and arms across the border to support their criminal activities there.[90] Hence, the impacts of money laundering are both microeconomic and macroeconomic in nature.[91]

Damage to the Private Sector

Damage to the private sector is another adverse effect that the money launderers cause to the economy of a nation. Money launderers often act through front companies, which acquire their funds. By acquiring large amounts of funds they can lower the prices of their services or products to a large extent to penetrate the market. They gain competitive advantage when other companies are not able to match their prices.[92] Hence, intense competition can devastate existing small and medium-sized private companies

[88] Novis & McDowell, *supra* note 85, at 7.
[89] Novis & McDowell, *supra* note 85, at 7.
[90] *See* WILLIAM BLAKE, A MANUAL OF PRIVATE INVESTIGATION TECHNIQUES, 222 (2013); SEE ALSO BARRY LEONARD, NATIONAL DRUG THREAT ASSESSMENT 2008 (2008).
[91] Novis & McDowell, *supra* note 85, at 7.
[92] Novis & McDowell, *supra* note 85, at 7.

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because smaller companies usually lack sufficient capital to bear the brunt of price competition.[93]

An example of this is the founding of a foreign exchange company, which may offer its services at a very low profit and then destroy the operations of other—certified—foreign exchange companies. Hence, that company will also proceed with money laundering activities without bringing it to the knowledge of the local government or by hiding the exact amount of the financial transactions that it carries out. Instances have occurred in the United States where money launderers have adopted this strategy, particularly for exchanging currencies of high international value with low-value regional currencies.[94]

Failure of Banks and Financial Institutions

Money laundering can cause the failure of banks and financial institutions. For instance, if a large sum of money is transferred to a bank and then, after a short duration, that money is transferred to another bank, it may cause a liquidity problem to the financial assets of that bank.[95] The bank can go bankrupt if a large number of people start approaching it to withdraw their deposits upon knowing that a massive amount of money has been moved from that bank by money launderers.[96] There are many examples of such incidents in history; for instance, the failures of the Liberty Reserve Bank[97] and Bank of Credit and Commerce International (hereinafter B.C.C.I.)[98] are both cases where banks have failed owing to money laundering.[99]

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[93] *See* Maurice E. Stucke, *Is Competition Always Good?*, 7 J. ANTITRUST ENFORCEMENT 162 (2013).

[94] *See* 1 LAWRENCE SALINGER, ENCYCLOPEDIA OF WHITE-COLLAR & CORPORATE CRIME 78 (2005).

[95] *See* MARGARET BEARE, ENCYCLOPEDIA OF TRANSNATIONAL CRIME AND JUSTICE, 37 (2012).

[96] *See* THE LAW SOCIETY, *Chapter 11: Money Laundering warning signs*, LAWSOCIETY.ORG.UK (Oct. 22, 2013),http://www.lawsociety.org.uk/support-services/advice/practice-notes/aml/money-laundering-warning-signs.

[97] For details about the case of the Liberty Reserve Bank, see: PHILIP MULLAN, THE DIGITAL CURRENCY CHALLENGE: SHAPING ONLINE PAYMENT SYSTEMS THROUGH U.S. FINANCIAL REGULATIONS (2014). *See also* SUSAN ROSE-ACKERMAN & BONNIE J. PALFIKA, CORRUPTION AND GOVERNMENT: CAUSES, CONSEQUENCES, AND REFORM (2ND ED., 2016).

[98] For details about the BCCI money laundering case, see: JOHN KERRY & HANK BROWN, THE BCCI AFFAIR: A REPORT TO THE COMMITTEE ON FOREIGN RELATIONS 202 (2012). *See also* JAMES R. RICHARDS, TRANSNATIONAL CRIMINAL ORGANIZATIONS, CYBERCRIME, AND MONEY LAUNDERING 44 (1999).

[99] *See also* ROBERT E. GROSSE, DRUGS AND MONEY: LAUNDERING LATIN AMERICA'S COCAINE DOLLARS 95 (2001).

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Reputation

Money laundering tarnishes the reputation of financial institutions and the nation's economy especially when money laundering also causes the embezzlement of funds etc. In such a case, market confidence diminishes and investors lose interest in the local market.[100] Moreover, if the speculations of the ill reputation of the market reach abroad, then it also reduces the chances of F.D.I.[101] This results in declining economic opportunities for the economy at both domestic and international levels. Hence, it eventually leads to weaker economic growth and it becomes harder to revive the economy.[102]

Impact on Economic Policy

As money laundering tarnishes the reputation of the financial institutions of a country, it might also affect the related economic indicators and variables, for instance the interest rate, which can affect inflation, Consumer Price Index (hereinafter C.P.I.), and the value of the currency of that country. This can cause monetary instability and can also affect the prices of goods in the country.[103]

Decline in Tax Revenues

Money laundering directly affects the government's tax revenue. As A huge sum of currency that could have been taxed is moved abroad. This loss of revenue must be covered by the government by collecting more taxes from other taxpayers by increasing the tax rate.[104] This hurts honest taxpayers, as well as making tax collection tougher for the government as the public may retaliate by protesting against the hike in tax rates.

[100] Novis & McDowell, *supra* note 85, at 8.
[101] *See* I Wayan Nasa Nugraha, *The Impact of Corruption and Money Laundering on Foreign Direct Investment in ASEAN*, 6 J. EKONOMI KUANTITATIF TERAPAN 106, 109 (2013).
[102] Novis & McDowell, *supra* note 85, at 8.
[103] Novis & McDowell, *supra* note 85, at 7.
[104] Novis & McDowell, *supra* note 85, at 8.

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2.4.2. SOCIAL IMPACTS

Money laundering gives birth to a number of social costs and dilemmas.[105] It also affects the reputation of a country at the international level if it appears that the financial institutions of that country might be involved in money laundering.[106] Furthermore, it can expose or encourage the people of a country to smuggling, drug trafficking, etc. Money laundering can also contribute to other crimes, as criminals, drug lords, smugglers, black money owners, etc. have to hide their source of income; moreover, they have to employ money laundering techniques to conceal their black money under the cloak of legality or safety from law enforcement agencies.[107] Hence, money laundering gives a safe haven to criminals and terrorists to hide their illegally earned money and, therefore, motivates others to enter the criminal world as they might consider any of the methods of money laundering to be a promoter and cover to their criminal activities.[108] Thus, crime will spread in society, which has not only geographical but also international implications because the nature of the crime has become global in scope.

3. GLOBAL MAGNITUDE AND COMBATING OF MONEY LAUNDERING

3.1. MAGNITUDE OF THE PROBLEM

Several financial regulatory organizations have attempted to predict the overall scale of money laundering. Michel Camdessus, the former managing director of the I.M.F., predicted that the total volume of money being laundered has reached approximately 55% of the total gross domestic product (G.D.P.) of all the countries in the world.[109]

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[105] Novis & McDowell, *supra* note 85, at 8. *See also* DONATO MASCIANDARO, GLOBAL FINANCIAL CRIME: TERRORISM, MONEY LAUNDERING, AND OFF SHORE CENTRES 63 (2004).
[106] Novis & McDowell, *supra* note 85, at 8.
[107] *See* U.S. DEP.'T JUST., DRUGS, CRIME, AND THE JUSTICE SYSTEM, 8 (1992).
[108] *See supra* note 60.
[109] Address by Michel Camdessus, Managing Director of the International Monetary Fund at the Plenary Meeting of the Financial Action Task Force on Money Laundering: the Importance of International Countermeasures, (February 10, 1998).

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Nonetheless, it is almost impossible to give an exact estimate of the total magnitude of money that is being laundered owing to the furtiveness associated with each of the money laundering methods.[110] The Financial Action Task Force (hereinafter F.A.T.F.)[111] confirms this: "Overall, it is absolutely impossible to produce a reliable estimate of the amount of money laundered."[112]

Similarly, researchers and scholars have also been unable to estimate the precise amount of money being laundered at the global level.[113] Nonetheless, rough estimates still suggest that the overall global volume of money laundering might be in the billions of U.S. dollars.[114]

3.2. CURBING MONEY LAUNDERING

As explained in the first section of this paper, money laundering causes adverse effects to the economy and society of a country; therefore, there is a need to curb this crime by banishing and eliminating all of the conditions that support it. Most nations, including Pakistan,[115] need to take serious but focused action immediately so as to rid this disease from and within society, particularly if the money laundering is widespread there. It is also notable to mention here that the curbing of money laundering will also cause a demise in other relevant criminal activities—for instance, drug trafficking, smuggling, and the financing of terrorism—because all of these crimes are financed by money laundering activities.[116]

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[110] *See* MARINELLA MARMO & NERIDA CHAZAL, TRANSNATIONAL CRIME AND CRIMINAL JUSTICE, 121 (2016). [Hereinafter Marmo & Chazal].

[111] The Financial Action Task Force (F.A.T.F.) is an international organization combating money laundering activities. To know more about F.A.T.F., *see*: OECD, THE FINANCIAL WAR ON TERRORISM: A GUIDE BY THE FINANCIAL ACTION TASK FORCE (2004). *See also* James K. Jackson, The Financial Action Task Force: An Overview, (CONGRESSIONAL RESEARCH SERVICE, 2012). JAMES K. JACKSON, CONG. RESEARCH SERV., RS21904, THE FINANCIAL ACTION TASK FORCE: AN OVERVIEW (2012).

[112] MARMO & CHAZAL, *supra* note 110, at 121.

[113] *See* DIANA KENDALL, SOCIOLOGY IN OUR TIMES,204 (2015).

[114] *See* GEORGE WALKER & JOSEPH NORTON, BANKS: FRAUD AND CRIME 203 (2013).

[115] In Pakistan, money laundering is pervasive, particularly in the elites; therefore, it needs to be given special treatment there. For details, see IMF, *Pakistan: 2009 Article IV Consultation and First Review Under the Stand-By Arrangement: Staff Report; Staff Statement; Public Information Notice and Press Release on the Executive Board Discussion; and Statement by the Executive Director for Pakistan*, IMF Country Report No. 09/123 (April 13, 2009).

[116] ASIAN DEVELOPMENT BANK, *supra* note 7. *See also* BRIGITTE UNGER & DAAN VAN DER LINDE, RESEARCH HANDBOOK ON MONEY LAUNDERING, 41 (2013).

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To end this disease from society, there are a few options—for instance, legislation, the judicious implementation of laws, strengthening the rule of law, the creation and collaboration of A.M.L. agencies at the national and international levels, strict security at airports and borders, enhanced accountability of politicians, and strict implementation of tax laws—that can be utilized.

3.2.1. INTERNATIONAL A.M.L. ORGANIZATIONS

There are several organizations that work to curb money laundering activities at the international level. The most prominent among them are mentioned below.

3.2.1.1. FINANCIAL ACTION TASK FORCE (F.A.T.F.)

In 1989, the G7[117] countries founded the F.A.T.F., headquartered in Paris, France.[118] At present, thirty-six countries are members of F.A.T.F.[119] The main purpose of F.A.T.F. is to devise an intergovernmental response for curbing money laundering;[120] however, in October 2001, after 9/11, it took on another essential goal in order to accomplish the combating the financing of terrorism.[121] It creates policies and strategies and gives advice to the governments for A.M.L. and Combating Financing Terrorism (hereinafter C.F.T.) laws and policy reforms.[122] It also monitors the government's financial activities to track any misappropriation related to money laundering regulations and provides suggestions to the governments upon identifying any

[117] The USA, Canada, the UK, France, Germany, Italy, and Japan.
[118] *See* ERROL P. MENDES, GLOBAL GOVERNANCE, HUMAN RIGHTS AND INTERNATIONAL LAW: COMBATING THE TRAGIC FLAW 213 (2014).
[119] *Id. See also* NORMAN MUGARURA, THE GLOBAL ANTI-MONEY LAUNDERING REGULATORY LANDSCAPE IN LESS DEVELOPED COUNTRIES 80 (2nd ed. 2016).
[120] *See* ANTHONY PAYNE & NICOLA PHILIPS, HANDBOOK OF THE INTERNATIONAL POLITICAL ECONOMY OF GOVERNANCE 171 (2014).
[121] *See* COMMONWEALTH SECRETARIAT, COMBATING MONEY LAUNDERING AND TERRORIST FINANCING: A MODEL OF BEST PRACTICE FOR THE FINANCIAL SECTOR, THE PROFESSIONS AND OTHER DESIGNATED BUSINESSES xi (2006).
[122] Cf. COMMONWEALTH SECRETARIAT, *supra* note 121, at xi.

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irregularities.[123] It can also suggest financial sanctions against countries that do not obey international regulations and policies.[124]

3.2.1.2. UNITED NATIONS OFFICE ON DRUGS AND CRIME

The United Nations Office on Drugs and Crime (hereinafter U.N.O.D.C.) maintains up-to-date data related to drug trafficking, smuggling, money laundering, and terrorism financing.[125] It was founded in 1997 to create a combined mechanism to curb money laundering and the illegal trafficking of drugs.[126] It also offers technical and financial assistance to governments to devise effective mechanisms for curbing money laundering.[127]

3.2.1.3. FINTRACA

FinTRACA, Financial Transactions and Reports Analysis Centre of Afghanistan, was founded in 2004 as an A.M.L. agency.[128] It is a semiprivate organization that works within Da Afghanistan Bank.[129] Its core function is to prevent access to the Afghan financial system to money launderers and those who are suspected of using the money to finance terrorism.[130] It works as a financial intelligence unit (hereinafter F.I.U.), gathering information and performing data analysis to track down the sources and destinations of money that come to or leave the Afghan financial system.[131] Upon tracking the illegal origins or destinations of money, it coordinates with security agencies and law

[123] *See* U.S. GOV'T ACCOUNTABILITY OFF.,GAO-09-794,COMBATING ILLICIT FINANCING 9 (2010). *See also* MIGRATION AND DEVELOPMENT: PERSPECTIVES FROM SMALL STATES (Wonderful Hope Khonje ed. 2015).
[124] *Id. See also* FATF Documents on the Forty Recommendations (FATF, August 2006).
[125] *See* International Money Laundering Information Network (IMOLIN) Publications / References (IMOLIN, 2013).
[126] *See* U.N. Secretary-General, Organization of the United Nations Office on Drugs and Crime, ¶1, U.N. Doc. ST/SGB/2004/6 (March 15, 2004).
[127] *Id.*
[128] *See* CHRISTOPHER J. CUBBAGE & DAVID J. BROOKS, CORPORATE SECURITY IN THE ASIA-PACIFIC REGION: CRISIS, CRIME, FRAUD AND MISCONDUCT 13 (2016).
[129] Central Bank of Afghanistan.
[130] CUBBAGE & BROOKS., *supra* note 128.
[131] CUBBAGE & BROOKS., *supra* note 128.

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enforcement departments to curb illegal financing activities and to investigate whether the money is being used to finance terrorism.[132]

3.2.2. INTERNATIONAL A.M.L. STANDARDS

There are several standards that are followed by several countries worldwide to form the basis of their policies to counter money laundering and the financing of terrorism. Some of the most prominent ones are mentioned below.

3.2.2.1. UNITED NATIONS CONVENTION AGAINST ILLICIT TRAFFIC IN NARCOTIC DRUGS AND PSYCHOTROPIC SUBSTANCES

Originally passed in 1988–1989, this convention offers a legal mechanism to combat drug trafficking at an international level.[133] The United Nations implemented this policy mechanism in 1989 and made it compulsory for its member states to follow this set of rules for combating drug manufacturing, distribution, and trafficking, which join hands with money laundering.[134]

3.2.2.2. UNITED NATIONS CONVENTION AGAINST TRANSNATIONAL ORGANIZED CRIME

Presented in 2000, this multilateral treaty is focused on curbing transnational organized crimes.[135] [136] The General Assembly of the United Nations adopted this treaty, also named the Palermo Convention, on November 15, 2000.[137] It has three core purposes:[138]

1. To thwart drug and human trafficking, particularly for women and children.

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[132] *See* IMF, *Detailed Assessment Report on Anti-Money Laundering And Combating The Financing Of Terrorism*, IMF Country Report No. 16/43 (February, 2016).
[133] *See US GOVERNMENT PRINTING OFFICE, UNITED NATIONS CONVENTION AGAINST ILLICIT TRAFFIC IN NARCOTIC DRUGS AND PSYCHOTROPIC SUBSTANCES : MESSAGE FROM THE PRESIDENT OF THE UNITED STATES TRANSMITTING THE UNITED NATIONS CONVENTION 1–27 (1989)*
[134] *Id.*
[135] Crimes that are coordinated across borders and have global implications.
[136] United Nations Convention Against Transnational Organized Crime and The Protocols Thereto, 1 (U.N.O.D.C., 2004). [Hereinafter: U.N.O.D.C.].
[137] *Id. See also* JAMES M. SCOTT, RALPH G. CARTER & A. COOPER DRURY, IR – INTERNATIONAL RELATIONS 376 (2nd ed. 2015).
[138] UNODC, *supra* note 136.

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2. To prevent the smuggling of migrants through all channels of traveling, i.e., sea, air, and land.

3. To prevent the illegal manufacturing of arms that might be used for terrorist activities.

These three purposes have been defined according to the contemporary international laws of money laundering and arms, drugs, and human trafficking.[139]

3.2.2.3. UNITED NATIONS CONVENTION AGAINST CORRUPTION

This convention contains seventy-one articles and eight chapters.[140] It puts emphasis on curbing corruption, bribery, the misappropriation of funds, and money laundering.[141] It also offers technical assistance, data exchange, and asset recovery mechanisms to the governments.[142]

3.2.2.4. F.A.T.F. RECOMMENDATIONS

The recommendations provided by the F.A.T.F. in 1989 have also been considered the basis of the A.M.L. laws that have been enacted worldwide.[143] The forty recommendations are related mainly to curbing organized crimes, drug trafficking, money laundering, and smuggling.[144]

3.2.3. CRITICISMS OF A.M.L. STANDARDS

The new regulations have also been criticized.[145] For instance, Yehudah Barlev, who has been a fraud investigator and is associated with an international

[139] *See* SCOTT ET AL. *supra* note 137.
[140] *See* UNODC's Action against Corruption and Economic Crime (UNODC, 2016).
[141] *Id.*
[142] *Id.*
[143] *See* PIERRE HAUCK & SVEN PETERKE, INTERNATIONAL LAW AND TRANSNATIONAL ORGANIZED CRIME 244 (2016).
[144] *See* FRANK HOLDER, INTEGRITY IN BUSINESS: DEVELOPING ETHICAL BEHAVIOR ACROSS CULTURES AND JURISDICTIONS 73 (CRC Press ed., 2nd ed. 2016). *See also* VALSAMIS MITSILEGAS, MONEY LAUNDERING COUNTER-MEASURES IN THE EUROPEAN UNION: A NEW PARADIGM OF SECURITY GOVERNANCE VERSUS FUNDAMENTAL LEGAL PRINCIPLES 48 (2003).
[145] For instance, the A.M.L. legislations in United States have been criticized a lot. For details, see

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agency, Barlev Investigative Accounting, considers the newly implemented A.M.L. laws to be "short-sighted" and easily violable by money launderers.[146] Moreover, criminals are still pursuing their activities by bypassing A.M.L. regulations and they usually find new methods to violate A.M.L. laws.[147] For instance, ATMs provide safe opportunities for terrorists to withdraw funds that are transferred to their accounts. Al-Qaeda members have been found to be continually using this method.[148]

In another instance, The Economist criticized the effectiveness of A.M.L. and C.F.T. regulations as "costly failures" because, on the one hand, they are causing huge costs for the implementation of A.M.L. and C.F.T. laws and, on the other hand, they have failed to prevent terrorists from receiving financing.[149] The Economist estimates that A.M.L. efforts cost the European Union and the United States. around $700 million in the year 2000 and this cost reached $5 billion within three years.[150]

Moreover, for what concerns providing training to employees of financial institutions, the issue is that financial organizations will not provide training as they consider it costly, as well as risky because the employees might leave the organization if they find a better job. In such a case the firm would get no benefit from training the employees.[151] Hence, the requirement to train employees in a financial organization becomes null and void.

3.3. NOTABLE INTERNATIONAL MONEY LAUNDERING CASES

In the past two to three decades, some cases of money laundering have grabbed the attention of the media owing to the unexpected identified criminal

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PETER REUTER & EDWIN M. TRUMAN, CHASING DIRTY MONEY: THE FIGHT AGAINST MONEY LAUNDERING 55 (2004).

[146] *See* Camilla Berens, *Expert Spies a Hole in the Law: Criminals Will Easily Find a Way Round the Regulations*, 33 FIN. MGMT. J. 5 (2004).

[147] *Id.*

[148] *Id.*

[149] *See Efforts to Combat the Financing of Terrorism are costly and ineffective*, THE ECONOMIST (Oct. 20, 2005), http://www.economist.com/node/5056338?story_id=e1_vdvgppr.

[150] *See Banks must fight money-laundering, but they need some help,* THE ECONOMIST (Oct. 14, 2004), http://www.economist.com/node/3292933.

[151] Berens, *supra* note 146.

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and the high volume of money laundering evidence found in these cases. Some prominent cases are mentioned below.

Bank of New York

The incident of money laundering took place in the late 1990s,[152] when Russian capital equivalent to U.S.$7.1 billion was laundered through bank accounts that were in control of some executives of the Bank of New York.[153] Reportedly, one of the vice presidents of the bank was identified as guilty of transferring capital and was charged with offenses after a thorough investigation was completed.[154] Initially, the bank was not found guilty and the offense remained toward the employee side of the bank;[155] however, after further investigations, in 2005, the bank accepted its mistake of not following the recommended procedure of A.M.L. regulations and paid $38 million in fines.[156]

Bank of Credit & Commerce International (B.C.C.I.)

B.C.C.I. was found guilty of laundering money for drug traffickers in the mid-1980s.[157] The estimated amount laundered was in the billions of dollars.[158] As a penalty for such a huge contribution to the crime, the bank was forced to close and was liquidated in 1991 upon the proving of the money laundering charges.[159]

[152] *See* THOMAS W. GOLDEN, STEVEN L. SKALAK, MONA M. CLAYTON & JESSICA S. PILL, A GUIDE TO FORENSIC ACCOUNTING INVESTIGATION 515 (2nd ed. 2015).
[153] *See* KRIS HINTERSEER, CRIMINAL FINANCE: THE POLITICAL ECONOMY OF MONEY LAUNDERING IN A COMPARATIVE LEGAL CONTEXT 5-6 (2002).
[154] *See supra* note 145.
[155] *See supra* note 145.
[156] *See* MICHAEL PARENTI, DEMOCRACY FOR THE FEW 102 (Wadsworth Publishing ed., 9th ed. 2010).
[157] *See* John Kerry & Senator Hank Brown, The BCCI Affair: A Report to the Committee on Foreign Relations, 202 (LULU.COM, 2011).
[158] *See* JAMES R. RICHARDS, TRANSNATIONAL CRIMINAL ORGANIZATIONS, CYBERCRIME, AND MONEY LAUNDERING: A HANDBOOK FOR LAW ENFORCEMENT OFFICERS, AUDITORS, AND FINANCIAL INVESTIGATORS 92 (1998).
[159] *See* ROBERT E. GROSSE, DRUGS AND MONEY: LAUNDERING LATIN AMERICA'S COCAINE DOLLARS 95 (13th ed. 2001).

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H.S.B.C.

H.S.B.C. was found to be involved in keeping laundered money and approving the transactions of drug traffickers, banned Iranian organizations, and terrorists from 2001 to 2010.[160] It was penalized in 2012 and paid around $1.9 billion in fines.[161]

Standard Chartered Bank

Standard Chartered Bank was found guilty of laundering billions of dollars for Iran for a decade in the 2000s.[162] It facilitated around 60,000 transactions for Iran and the total worth of these transactions was approximately $250 billion.[163] The bank was fined $340 million for its involvement in laundering money and facilitating illegal transactions.[164]

Liberty Reserves Bank

The Liberty Reserves bank of Costa Rica was found to be involved in laundering around $6 billion.[165] After the proving of the charge, the bank was suspended and closed by U.S. federal authorities.[166]

Vatican Bank

The Vatican Bank in the Vatican City, known in Italian as Istituto per le Opere di Religione (I.O.R.),[167] was charged with facilitating monetary transactions found to be linked with money laundering.[168] The bank was investigated by the

[160] *See* LOUISE I. SHELLEY, DIRTY ENTANGLEMENTS: CORRUPTION, CRIME, AND TERRORISM 196 (2014).
[161] *See* ORDE F. KITTRIE, LAWFARE: LAW AS A WEAPON OF WAR 159 (2016).
[162] For details, see: ORDE F. KITTRIE, LAWFARE: LAW AS A WEAPON OF WAR 144 (2016).
[163] *See* PHILIPPA X. GIRLING, OPERATIONAL RISK MANAGEMENT: A COMPLETE GUIDE TO A SUCCESSFUL OPERATIONAL RISK FRAMEWORK (2013). *See also* RONALD J. BURKE & SUZY FOX, HUMAN FRAILTIES: WRONG CHOICES ON THE DRIVE TO SUCCESS 77 (2016).
[164] *See* NIR KOSSOVSKY, MICHAEL D. GREENBERG & ROBERT C. BRANDEGEE, REPUTATION, STOCK PRICE, AND YOU: WHY THE MARKET REWARDS SOME COMPANIES AND PUNISHES OTHERS 193 (2012).
[165] *See* JOHN A. ROTHCHILD, RESEARCH HANDBOOK ON ELECTRONIC COMMERCE LAW 54 (2016).
[166] *See* CLARE CHAMBERS-JONES & HENRY HILLMAN, FINANCIAL CRIME AND GAMBLING IN A VIRTUAL WORLD: A NEW FRONTIER IN CYBERCRIME 160 (2014).
[167] Translated as the "Institute of the Works of Religion."
[168] *See* FAUSTO MARTIN DE SANCTIS, CHURCHES, TEMPLES, AND FINANCIAL CRIMES: A JURIDICAL PERSPECTIVE OF THE ABUSE OF FAITH 72-73 (2015).

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Italian authorities and $30 million were seized from the bank as a punishment for facilitating the money laundering transactions.[169]

Previously, the Vatican Bank had also been found to be linked with a monetary scandal of around $1.3 billion and the collapse of $3.5 billion currency worth of the Banco Ambrosiano in 1982.[170] The Vatican Bank did not accept the charges, though it paid $250 million in fines for the embezzlement of funds in the 1980s.[171]

3.4 A.M.L. LEGISLATION IN DIFFERENT COUNTRIES

The international community has given particular attention to curbing money laundering since 9/11. New laws, rules, and regulations have been made under the International Convention for the Suppression of the Financing of Terrorism.[172] The F.A.T.F. in particular has played an effective role in implementing its A.M.L. approach by intervening in international cases of money laundering.[173]

3.4.1. THE U.S.

The U.S. has been affected by money laundering to a very great extent. The hilly terrain along the Mexico–U.S. border makes it difficult for U.S. border security forces to keep watch over each part of the border. This unsafe border[174] has made it challenging for U.S. security agencies, particularly its southern border surveillance agencies, to track and prevent drug lords and smugglers from making their way to the United States. Smugglers also enter the Unites States from Mexico by digging hidden tunnels and thus crossing the border

[169] *See* RACHEL DONADIO, *Money-Laundering Inquiry Touches Vatican Bank,* NYTIMES.COM (Sept. 20, 2010), http://www.nytimes.com/2010/09/22/world/europe/22vatican.html.
[170] *Id. See also*: MAANOJ RAKHIT, SEED 8: BEWARE OF THIS AASURIC CULTURE 45 (2009).
[171] DONADIO, *supra* note 169.
[172] *See* ANA SALINAS DE FRÍAS, KATJA SAMUEL, AND NIGEL WHITE, COUNTER-TERRORISM: INTERNATIONAL LAW AND PRACTICE 17 (2012).
[173] *See* BRIGITTE UNGER, IOANA DELEANU, JORAS FERWERDA & MELISSA VAN DEN BROEK, THE ECONOMIC AND LEGAL EFFECTIVENESS OF THE EUROPEAN UNION'S ANTI-MONEY LAUNDERING POLICY 20 (2014).
[174] *See* JEROME ROBERT CORSI & JIM GILCHRIST, MINUTEMEN: THE BATTLE TO SECURE AMERICA'S BORDERS 162 (2006).

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furtively through the underground tunnels or mountains.[175] Recently, an 800 yard-long tunnel was discovered that connected the U.S. to Mexico across the border and half a mile underneath California.[176] An estimated two tons of cocaine were seized from the same tunnel.[177] As a result, money laundering and drug trafficking activities have been prevailing in that border region; its effects also reach the U.S., being felt more profoundly in particular regions, and have caused a constant worry for U.S. law enforcement and financial regulatory agencies.

The United States has placed a high importance on money laundering by regulating two areas: 1) preventive money laundering measures and 2) criminal offenses measures.

3.4.1.1. PREVENTIVE MONEY LAUNDERING MEASURES

The United States Congress has enacted various laws to prevent money laundering activities. The first law, the Bank Secrecy Act (hereinafter B.S.A.),[178] was passed in 1970, and since then a series of amendments as well as new Acts have been proposed, debated, and implemented. These laws regulate the activities of banks, brokers, and other financial institutions. These laws make it compulsory for financial organizations and individuals to report any suspicious money laundering activity to the U.S. Department of Treasury.[179] The FinCEN works as the U.S. F.I.U. and investigates these reports.[180] Banks have also been advised to provide training to their employees to identify and avoid the money laundering and suspicious transactions, as regulated by the Money Laundering and Financial Crimes Strategy Act of 1998.[181]

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[175] *See* FELIA ALLUM & STAN GILMOUR, THE HANDBOOK OF THE TRANSNATIONAL ORGANIZED CRIME 194 (2012).
[176] *See* AZADEH ANSARI, *US-Mexico drug tunnel spanned 800 yards, held 2 tons of cocaine*, EDITION.CNN.COM (Apr. 21, 2016), http://edition.cnn.com/2016/04/20/us/u-s-mexico-drug-tunnel.
[177] *Id.*
[178] GEE, *supra* note 44.
[179] GEE, *supra* note 44.
[180] *See* JOHN ROLLINS, INTERNATIONAL TERRORISM AND TRANSNATIONAL CRIME: SECURITY THREATS, U.S. POLICY, AND CONSIDERATIONS FOR CONGRESS 36 (2010). *See also* : DAVID S. KERZNER AND DAVID W. CHODIKOFF, INTERNATIONAL TAX EVASION IN THE GLOBAL INFORMATION AGE 365 (2016). *See* more details about F.I.U. at: IMF, World Bank, *Financial Intelligence Units: An Overview*, IMF Publications (June 2004).
[181] *See* U.S. CONGRESS, PUBLIC LAW 105–310 (1998).

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However, attempts have also been made to violate this law. For instance, transactions that exceed $10,000,[182] must be reported,[183] but offenders violate this rule by breaking the total amount of cash transaction into amounts smaller than $10,000 and then depositing, withdrawing, or transacting from different locations. This is still considered a legal violation in the United States because the actual amount of the transactions is kept hidden from the government and no information is provided about the original source of the money.[184]

To keep a watchful eye on the transactions carried out by the customers of financial institutions, the B.S.A. authorizes financial institutions, including banks, to use the Know Your Customer (K.Y.C.) strategy.[185] This strategy entails adopting a thorough understanding of the nature of the customer's financial account, as well as their full name, address, and other details, and information on the origin of money that reaches the customer's account.[186] In the U.S., all bank accounts are scrutinized by software to audit financial transactions and flag any suspicious or misreported transactions.[187] If any suspicious transaction is found, it is included in a suspicious activity report, which is filed by the financial institution to the Department of Treasury.[188]

In addition, the Department of Treasury devised a national money laundering strategy, which allowed the creation of a special task force with the name of High Intensity Financial Crime Area (hereinafter H.I.F.C.A.).[189] H.I.F.C.A. inspects, tracks, and curbs money laundering activities at every level,

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[182] The limit was originally $5000 but as a result of demands from large business and trading companies, it was raised to $10,000 by the Bank Secrecy Act. For details, see: 2 GYEORGOS C. HATONN, PRIVACY IN FISHBOWL 128 (1995).

[183] *See 31 C.F.R. § 0-199 (2009) at 433.*

[184] GEE, *supra* note 44.

[185] *See* GILL PEELING & TIM PARKMAN, COUNTERING TERRORIST FINANCE: A TRAINING HANDBOOK FOR FINANCIAL SERVICES 89 (2007).

[186] *See, e.g.,* a case study related to the implementation of KYC Strategy*: :* Linah Ottichilo & Robert Arasa, *Determinants of Know Your Customer (KYC) Compliance among Commercial Banks in Kenya,* 7 J. ECON. & BEHAV. STUD. 163 (2015).

[187] *See* DOUGLAS GREENBURG, JOHN ROTH & SERENA WILLIE, *Monograph on Terrorist Financing*, LIBRARY.UNT.EDU (Aug. 2004), http://govinfo.library.unt.edu/911/staff_statements/911_TerrFin_Monograph.pdf, 54-56.

[188] *Id.*

[189] *See* WILLIAM C. MICHAELS, NO GREATER THREAT: AMERICA AFTER SEPTEMBER 11 AND THE RISE OF A NATIONAL SECURITY STATE 91 (2007). *See also* JENNIFER E. LAKE, SOUTHWEST BORDER VIOLENCE: ISSUES IN IDENTIFYING AND MEASURING SPILLOVER VIOLENCE 32 (2010).

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i.e., local, state, and federal.[190] The Intelligence Reform & Terrorism Prevention Act of 2004 relates to the prevention of terrorism financing by curbing money laundering by transferring currency across the border.[191]

3.4.1.2. CRIMINAL OFFENSES MEASURES

As per the U.S. Money Laundering Control Act of 1986, money laundering is a crime.[192] The Act prohibits individuals from hiding the source of their financial earnings as well as receiving money that has been earned through crime.[193] Moreover, any action of transferring money, whether or not any financial institution is involved, is considered a financial transaction even if it is merely passing a bag of money from one person to another.[194] If that transfer is intended to conceal the source of the money, then it will be considered unlawful.[195]

3.4.1.3. IMPACTS OF A.M.L. LEGISLATION

Financial institutions that fail to conform to the rules devised by the B.S.A. are fined and punished according to the severity level of their noncompliance.[196] For instance, Riggs Bank was prosecuted and then closed owing to its failure to follow the B.S.A. for applying A.M.L. rules to the foreign financial transactions that its customers were carrying out.[197] A number of institutions, including the Federal Reserve and the Office of Comptroller of the Currency, examine the transactions of banks and of all other financial institutions.[198] The F.B.I. also

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[190] *See* FINANCIAL CRIMES ENFORCEMENT NETWORK, U.S. DEP'T OF TREASURY, WHAT IS A HICFA? (2014)
[191] *Id. See also* ETHAN NADELMANN & PETER ANDREAS, POLICING THE GLOBE: CRIMINALISATION AND CRIME CONTROL IN INTERNATIONAL RELATIONS 192 (2006).
[192] *See* RICHARD D. ATKINS, THE ALLEGED TRANSNATIONAL CRIMINAL: THE SECOND BIENNIAL INTERNATIONAL CRIMINAL LAW SEMINAR 224 (1995). *See also* BENTON GUP, BANKING AND FINANCIAL INSTITUTIONS: A GUIDE FOR DIRECTORS, INVESTORS, AND BORROWERS 238 (2011).
[193] *See* Stefan Cassella, *Money Laundering Laws*, U.S ATT'Y BULL., Sept. 2007, at 21-34
[194] *Id.*
[195] *Id.*
[196] *See* USA PATRIOT ACT: ADDITIONAL GUIDANCE COULD IMPROVE IMPLEMENTATION OF REGULATIONS RELATED TO CUSTOMER IDENTIFICATION AND INFORMATION SHARING PROCEDURES: REPORT TO CONGRESSIONAL REQUESTERS 53 (2005).
[197] *See Lester Joseph & John Roth, Criminal Prosecution of Banks Under the Bank Secrecy Act,* U.S ATT'Y BULL., Sept. 2007
[198] *See* D. R. CARMICHAEL & LYFORD GRAHAM, ACCOUNTANTS' HANDBOOK, SPECIAL INDUSTRIES AND SPECIAL TOPICS (12th ed. 2012). *See also* : 1 CYNTHIA CLARK NORTHRUP, THE AMERICAN ECONOMY: A HISTORICAL ENCYCLOPEDIA 591 (2003).

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becomes involved if it has to investigate the money laundering in relation to another crime.[199]

To prevent cross-border cash smuggling, the U.S. government has criminalized any unreported transfer of cash exceeding $10,000 across the border.[200] To move such an amount for business or trade purposes, it has to first be filed on an International Transportation of Currency or Monetary Instruments Report (C.I.M.R.) or else it is considered money laundering.[201] Similarly, businesses such as automobile dealerships, which have to transport automobiles from one region to another and have to transfer a high amount of cash from one dealership to another, are required to file Form 8300 with the International Revenue Service[202] to describe and confirm the source of the cash.[203]

3.4.2. THE U.K.

The United Kingdom has enacted new laws for curbing the roots of money laundering from its territory. For instance, it passed three major laws immediately after the 9/11 attacks.[204] These include:

- The Criminal Justice and Police Act 2001
- The Anti-Terrorism, Crime and Security Act 2001
- The Proceeds of Crime Act 2002
- The Serious Organised Crime and Police Act 2005
- The Money Laundering Regulations 2007

All of these Acts make it compulsory for the government to prevent money laundering activities and arrest as well as penalize those found to be involved

[199] *See* JANINE KREMLING & LARRY K. GAINES, DRUGS, CRIME & JUSTICE: CONTEMPORARY PERSPECTIVES 343 (3rd ed. 2013). *See also* : 7 EDWARD V. LINDEN, FOCUS ON TERRORISM 116 (2007).
[200] *See 31 C.F.R. § 0-199 (2009) at 433.*
[201] U.S. SECURITIES & EXCHANGE COMMISSION, *Anti-Money Laundering (AML) Source Tool for Broker-Dealers,* SEC.GOV (Jan. 11, 2017), https://www.sec.gov/about/offices/ocie/amlsourcetool.htm#8.
[202] Internal Revenue Service (I.R.S.).
[203] *See* Forms and Publications: DEPARTMENT OF THE TREASURY, *Form 8300*, IRS.GOV (Aug. 2014),https://www.irs.gov/pub/irs-pdf/f8300.pdf?_ga=1.129197324.1049031876.1480449123.
[204] *See* MARY MICHELLE GALLANT, MONEY LAUNDERING AND THE PROCEEDS OF CRIME: ECONOMIC CRIME AND CIVIL REMEDIES, 21–22 (2005). *See also* : Antonio Vercher, *The Alleged Transnational Criminal: The Second Biennial International Criminal Law Seminar*, 4 EUR. J. CRIME CRIM. L. & CRIM. JUST. 414 (1996).

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in money laundering.[205] Provisions have also been added that highlight the importance of providing training and knowledge to the general public.[206] For instance, the Proceeds of Crime Act 2002 makes it mandatory for financial organizations to provide training and knowledge to their employees about preventing money laundering and identifying any activity that may constitute money laundering.[207] If an organization or the relevant person in that organization fails to report a suspicious money laundering activity, a punishment of five years' imprisonment is levied on that organization/person.[208] The punishment for carrying out money laundering offenses as an individual can amount to forteen years' imprisonment.[209] The same punishment was added in the Money Laundering Regulations 2003,[210] which was amended and replaced by the new Money Laundering Regulations in 2007[211] and enacted as per EU directives 91/308/EEC, 2001/97/EC, and 2005/60/EC.[212]

Not only does the action of transferring cash from abroad constitute money laundering, but tax evasion, hiding property liable to taxation, misappropriating tax records, embezzling funds in a financial organization, and helping someone perform money laundering are also included in the clauses of A.M.L. Acts in the United Kingdom.[213] The punishment for each case is determined by the courts according to the severity of the violation and the individual's contribution to the crime.[214]

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[205] For details, see: IMF, *British Virgin Islands-Overseas Territory of the United Kingdom: Assessment of the Supervision and Regulation of the Financial Sector Volume II-Detailed Assessment of Observance of Standards and Codes,* Part A, IMF Country Report No. 04/93 (April, 2004).
[206] *Id.*
[207] Proceeds of Crime Act 2002, §334.
[208] *Id.*
[209] *See* NICHOLAS LORD, REGULATING CORPORATE BRIBERY IN INTERNATIONAL BUSINESS: ANTI-CORRUPTION IN THE UK AND GERMANY (2016).
[210] *See* BRIGITTE UNGER, DONATO MASCIANDARO & ELOD TAKATS, BLACK FINANCE: THE ECONOMICS OF MONEY LAUNDERING 116 (2007).
[211] *See* MARK SUTHERLAND WILLIAMS & TREVOR MILLINGTON, MILLINGTON AND SUTHERLAND WILLIAMS ON THE PROCEEDS OF CRIME, 544 (2010).
[212] PARKER HOOD, PRINCIPLES OF LENDER LIABILITY 116 (2016). For details about the directives, seeMARIA BERGSTRÖM, THEODORE KONSTANDINIDES & VALSAMIS MITSILEGAS, RESEARCH HANDBOOK ON EU CRIMINAL LAW 240 (2016).
[213] U.K. is a member of FATF, and the above-mentioned aspects are included in the recommendations provided by the FATF. Therefore, as a member of FATF, U.K. has to comply with FATF recommendations and consider these aspects into the categories of money laundering. For details, see CHRISTOPHER WESTPHAL, DATA MINING FOR INTELLIGENCE, FRAUD & CRIMINAL DETECTION: ADVANCED ANALYTICS & INFORMATION SHARING TECHNOLOGIES 144 (2008).
[214] *See Postulate 51 in*: Great Britain Parliament and Joint Committee on Human Rights, The UN

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The A.M.L. statutes and their amendments have played an essential role in tracking the money launderers. After the A.M.L. Regulations of 2007–08, a number of reports have been submitted to the U.K. government by financial organizations regarding suspicious money laundering transactions. For instance, in 2009, approximately 228,834 reports were submitted to the government by organizations and employees.[215] This number increased in 2010, when 240,582 reports were provided.[216] The number increased again in 2011 to over 250,000.[217] Importantly, each year, 80% of the reports were provided by banks and financial institutions.[218] This gives an indication of how seriously financial organizations and individuals were reporting suspected money laundering activities to the government.

Although investigations were made and not all cases that were reported were considered money laundering offenses, the high level of reporting suggests that corporations, banks, and the general public have taken the need to avoid money laundering seriously.

4. MONEY LAUNDERING AND PAKISTAN

Money laundering has taken hold in Pakistan.[219] This crime has flourished over the last three decades through black money, which the political and elite classes possess alongside having political influence and power in the country.[220] Unfortunately, no government during this period has been successful in effectively implementing laws to curb money laundering and its precursor crimes, such as drug trafficking, smuggling, and corruption;[221]

Convention Against Torture (UNCAT): Nineteenth Report of Session 2005-06, Ev 72 (THE STATIONERY OFFICE, 2006). *See also* ALASTAIR R. MOWBRAY, CASES, MATERIALS, AND COMMENTARY ON THE EUROPEAN CONVENTION ON HUMAN RIGHTS 337 (2012).

[215] THE SERIOUS ORGANISED CRIME AGENCY, THE SUSPICIOUS ACTIVITY REPORTS REGIME ANNUAL REPORT (2010).

[216] *Id.*

[217] *Id.*

[218] *Id.*

[219] IMF, *supra* note 115, at 20.

[220] CHRISTOPH SCHREUER, FEDERICO ORTINO & PETER MUCHLINSKI, THE OXFORD HANDBOOK OF INTERNATIONAL INVESTMENT LAW 586 (2008).

[221] MOEED W. YUSUF ET AL., PAKISTAN'S COUNTERTERRORISM CHALLENGE 165 (Moeed W. Yusuf ed., 2014). [Hereinafter Yusuf].

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neither has the government devised any effective mechanisms to combat tax evasion. People try to evade taxes as tax laws are not strict enough to make them accountable for unpaid taxes.[222] Although new laws have aimed at curbing money laundering, they have lost effectiveness as the government has never discouraged the patterns in society that facilitate money laundering.[223]

4.1. CHANNELS OF MONEY LAUNDERING

Money laundering is carried out in Pakistan through different channels, as explained below.

4.1.1. DRUG TRAFFICKING

Pakistan is in the Golden Crescent region,[224] an area where opium and its cultivation and trade are widespread,[225] owing to its geographical location. Its neighboring countries, Iran, Afghanistan, and India, have a high volume of opium cultivation and trade origins.[226] Drug trafficking within these countries, as well as across their boundaries, takes place regularly because the borders, especially the Afghanistan–Pakistan, Iran–Pakistan, and Iran–Afghanistan borders, are not strictly protected and monitored. Drug traffickers move the drugs across the border and get cash in return from the drug lords, who are pursuing their activities furtively in Pakistan as well as in its neighboring countries.[227] The cash movement is usually unreported and is surreptitiously carried out, which is in itself money laundering.

Owing to the high prices of the drugs that are trafficked along the borders of Pakistan, the amount of cash moved is usually very high, sometimes in the hundreds of millions of Pakistani rupees. Thus, a high amount of currency is laundered by the drug traffickers as "black money" or "dirty

[222] *See* M. ALI KEMAL, A FRESH ASSESSMENT OF THE UNDERGROUND ECONOMY AND TAX EVASION IN PAKISTAN: CAUSES, CONSEQUENCES, AND LINKAGES WITH FORMAL ECONOMY 14 (2007).
[223] YUSUF ET AL., *supra* note 221.
[224] *See* VEENA KUKREJA, CONTEMPORARY PAKISTAN 193 (2003).
[225] *See* KUSHRO FARAMURZ RUSTAJMI ET AL., POLICING IN INDIA IN THE NEW MILLENNIUM 658 (P.J. Alexander ed., 2002).
[226] *See* Drugs Sub-Directorate: Heroin (INTERPOL, 2007).
[227] *See* 1 BUREAU FOR INTERNATIONAL NARCOTICS AND LAW ENFORCEMENT, U.S. DEP'T OF STATE, INTERNATIONAL NARCOTICS CONTROL STRATEGY REPORT 353 (2010) [Hereinafter: Brownfield].

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money" and stays unchecked, particularly if the drug traffickers have good contacts within the establishment or government as they can give bribes to the relevant authorities or can also use power to ensure their safe conduct.[228]

Pakistan's northwestern border with Afghanistan is too long to have surveillance over and can be too costly for the government to keep a continuous check over it, whether using manual or automated surveillance systems.[229] The absence of constant surveillance has assisted smugglers and drug traffickers throughout history and they have been successful in establishing their underground drugs and money laundering empire by smuggling merchandize and drugs in both directions across the border, and by moving cash in a similar fashion.[230] This has strengthened the money laundering and untaxed trade, which has now emerged as a giant market that has the capability to rival the local market economy in Pakistan's North-West Frontier Province.[231]

4.1.2. SMUGGLING OF CASH

Cash is smuggled across the borders of Iran and Afghanistan,[232] as well as through airports. For this, smugglers try to evade the security checks to launder money and they also bribe authorities or someone in the surveillance team to let them move the cash abroad.[233]

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[228] *See* DAVID C. JORDAN, DRUG POLITICS AND DEMOCRACIES 152 (2016).

[229] *See Addiction, Crime and Insurgency: The Transnational Threat of Afghan Opium*, UNODC (Oct. 2009), http://www.unodc.org/documents/data-and-analysis/Afghanistan/Afghan_Opium_Trade_2009_web.pdf.

[230] *Id. See also* : 22 U.S.C. (2006), Suppl. 3, Volume 3, p. 42 (US GOVERNMENT PRINTING OFFICE, 2010). *See also* : ARVIND GOSWAMI, 3D DECEIT, DUPLICITY & DISSIMULATION OF U.S. FOREIGN POLICY TOWARDS INDIA, PAKISTAN & AFGHANISTAN 112 (2012).

[231] For instance, as per the estimates of the World Bank in 2001, the trade at the Pakistan–Afghanistan border exceeded $1 billion. Since then, the yearly trade volume exceeds a billion dollars. This is a huge amount for the economy of any country and cannot be neglected. For details, see BARNETT R. RUBIN, AFGHANISTAN FROM THE COLD WAR THROUGH THE WAR ON TERROR 375 (2015).

[232] Brownfield, *supra* note 227.

[233] For instance, see DELILA AMIR ET AL., TRAFFICKING AND THE GLOBAL SEX INDUSTRY 67 (2006). *See also* : ARTHUR CONAN DOYLE, THE ADVENTURES OF SHERLOCK HOLMES AND THE CABLEGATE FILES OF WIKILEAKS 40 (2011). *See also* ALEC DUBRO & DAVID KAPLAN, YAKUZA: JAPAN'S CRIMINAL UNDERWORLD 255 (2012).

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4.1.3. CORRUPT POLITICIANS AND ADMINISTRATORS

Regrettably, corrupt politicians and administrators are paving the way for major crimes to take hold in the country, for instance corruption, bribery, money laundering, and "whitening" black money.[234] The corrupt officeholders are promoting these crimes either by becoming directly involved in money laundering, making offshore properties, drug trafficking, smuggling, corruption, misappropriation of funds, bribery, etc. or by taking bribes from those who are involved in such crimes.[235] Reportedly, investigations have also been launched against some politicians accused of having contact with smugglers, money launderers, and drug lords.[236]

In this regard, it is not only politicians but also personnel in the administrative and anticorruption departments who have been found guilty of taking bribes from money launderers, who have been allowed to take huge amounts of cash out of the country and, in return, took bribes from them. Employees in the antinarcotics squads and airport authorities have assisted money launderers and drug traffickers in taking currency abroad.[237] There is a need to keep a strict check on personnel, as well as on those who are working in such departments, where money launderers can entice someone by giving large bribes to allow their money laundering activities.[238]

4.1.4. REAL ESTATE BUSINESS

Some money launderers buy property using laundered or black money and then sell the property quickly for someone to buy it and give them the money, which will then be considered "legitimately earned." This facilitates them in whitening their black money and leads to the crime of money laundering.[239]

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[234] *See* IBP INC., PAKISTAN: DOING BUSINESS AND INVESTING IN PAKISTAN: STRATEGIC, PRACTICAL INFORMATION, REGULATIONS, CONTRACTS 126 (2015). [Hereinafter: IBP].
[235] *Id.*
[236] Brownfield, *supra* note 227.
[237] For instance, see AFP, *Report Unmasks Tax Evasion Among Pakistan Leaders. The Express Tribune* (Dec. 12, 2012), http://tribune.com.pk/story/478812/report-unmasks-tax-evasion-among-pakistan-leaders.
[238] IBP INC. *supra* note 234.
[239] *See* SHAHRAM HAQ, *Property Market Befuddled by Tax Measures*, THE EXPRESS TRIBUNE (Aug. 26, 2016), http://tribune.com.pk/story/1170097/property-market-befuddled-tax-measures.

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4.1.5. TAX EVASION

Many elites in the country avoid paying taxes.[240] For this, they usually bribe the tax office employees to either show their tax status as "paid" or to not notify he tax authorities of the fact that the tax has not been paid.[241] Usually, the bribe is a small chunk of the tax amount, which rich people never hesitate to give and the worker who receives it considers very good,[242] because the salaries of government workers are not sufficiently high to afford a fashionable lifestyle. A large number of incidences of bribery have led Pakistan to have the highest prevalence of bribery in South Asia.[243]

Money launderers also bribe officials of the relevant A.M.L. authorities to allow the transfer of large amounts of cash abroad and label the transfer as "clean" without paying the applicable tax on it, by either reporting an incorrect amount of transferred cash or not reporting it at all.[244] Hence, money laundering proceeds in two ways, i.e., by evading taxes and by transferring cash to foreign banks successfully for the sake of getting property abroad, and the widespread culture of bribes plays an essential role in supporting this.

4.1.6. HUNDI

Hundi has been a major channel of money laundering in India and Pakistan.[245] Through this method, overseas nationals send remittances to their relatives, friends, family, etc.[246] It works as a credit transfer or IOU and transfers money without actually moving it from one region to another.[247] As a result, neither

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[240] NICHOLAS GALASSO & RICARDO FUENTES-NIEVA, WORKING FOR THE FEW: POLITICAL CAPTURE AND ECONOMIC INEQUALITY 15 (2014). *See also* : Tax in Developing Countries: Increasing Resources for Development, Fourth Report of Session 2012–13 of House of Commons and Parliament of Great Britain, Vol 1, Ev 14 (THE STATIONERY OFFICE, 2012).

[241] Bribery to avoid tax is among the major problems of Pakistan causing low tax revenue for it. For details, see ANAS MALIK, POLITICAL SURVIVAL IN PAKISTAN: BEYOND IDEOLOGY 170 (2010).

[242] *See* WAHEED MUGHAL, BEYOND LONDON 162 (2010).

[243] *See* TEHREEM HUSSAIN, *Bribery incidence in Pakistan much higher than rest of South Asia*, THE EXPRESS TRIBUNE (May 23, 2016), https://tribune.com.pk/story/1108179/illegal-behaviour-corruption-anathema-society/.

[244] IBP INC. *supra* note 234.

[245] *See* PETER LILLEY, DIRTY DEALING: THE UNTOLD TRUTH ABOUT GLOBAL MONEY LAUNDERING, INTERNATIONAL CRIME AND TERRORISM 142 (2003).

[246] *See* JOHN CHIBAYA MBUYA, THE PILLARS OF BANKING 116 (2008).

[247] The branch or representative person of Hundi in the foreign country takes the cash and asks the representative in the other country to give an equal or smaller amount of cash to the concerned person to whom the cash has to be sent.

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the government nor the economy notices the transfer, which directly makes it a money laundering channel.

Although the government of Pakistan has made this method of money transfer illegal,[248] there are still many Hundi operators working in the country surreptitiously and it might also be possible that some foreign exchange companies use this process to hide their taxable earnings from the government.[249] In addition, a study indicated that the total volume of annual currency transfers through Hundi is around $15 billion,[250] which is a significant amount and indicates the strength of the Hundi channel for laundering money.

4.2. TERRORISM FINANCING

Terrorists require money to finance their activities.[251] The sponsorship is provided by their patrons, who are usually found to be money launderers and drug traffickers, and sometimes politicians and the elite of society, who support them in a disguised manner. Nonetheless, funding from foreign anti-state elements overshadows all other sources of terrorist funding, which establishes the pathways of money laundering.[252] Terrorist organizations have been found to be involved in money laundering.[253] This has been found to be true particularly in Pakistan,[254] where foreign intelligence agencies, namely RAW,[255] Blackwater, and the CIA,[256] have been found to be involved with terrorists and to have financed anti-state elements.[257]

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[248] *See* ARIF HASAN & MANSOOR RAZA, MIGRATION AND SMALL TOWNS IN PAKISTAN 40 (2009).

[249] For instance, Human Rights Watch explains that each year the estimated remittances sent by overseas nationals to Pakistan are not the exact amount of remittances, because these do not include those remittances that are sent through informal channels, i.e., Hundi and Hawala. The remittances sent through Hundi remain untracked. For details, see HUMAN RIGHTS WATCH, "BAD DREAMS": EXPLOITATION AND ABUSE OF MIGRANT WORKERS IN SAUDI ARABIA 2004.

[250] SHAHID IQBAL, *Annual Hundi, Hawala payments cross $15 billion*, DAWN.COM (Dec. 31, 2015), http://www.dawn.com/news/1229711.

[251] *US CONGRESS, CONGRESSIONAL RECORD*, *VOLUME* 151, Pt. 12, July 14 to July 22, 2005, 16983-84 (2005).

[252] ARUN KUMAR, THE BLACK ECONOMY IN INDIA, 261 (2002).

[253] *Id.*

[254] IMF, *supra* note 115, at 20.

[255] The *Research and Analysis Wing (RAW)* is an army intelligence agency of India.

[256] Blackwater and the Central Intelligence Agency (CIA) are the intelligence agencies of the US.

[257] ERIC DRAITSER, *The Politics of Terrorism in Pakistan,* NEO (Jul. 8, 2014), http://journal-neo.org/2014/07/08/the-politics-of-terrorism-in-pakistan.

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For instance, the recent incident of arrest of an Indian Army intelligence officer, Kalbhushan Yadav, who was found to be commanding a strong terrorist network in Pakistan,[258] is a clear instance of the Indian Army RAW's involvement in funding anti-state terrorist activities, which were pursued by Kalbhushan Yadav's network in different areas of Pakistan, particularly Quetta and Karachi.[259] The tarnished peaceful situation of Karachi is also a consequence of that terrorist network's surreptitious financing by either foreign agencies or local people.[260]

Now, in such cases, all the money that the terrorists receive is actually "laundered" money, because it is kept hidden and neither its original source nor its destination are revealed to the government by the financers.[261] Hiding the source and channels of money is essential for the terrorists to continue financing their activities without being traced by local law enforcement agencies. Hence, money laundering goes hand-in-hand with terrorist activities.[262]

4.3. PAKISTAN AND INTERNATIONAL A.M.L. STANDARDS AND ORGANIZATIONS

Pakistan has never exercised a leading role in any of the A.M.L. international standards or organizations,[263] although Pakistan has been a member of them and has actively participated in the meetings of these conventions and organizations since their founding. Pakistan also gets support from the U.N.O.D.C. in terms of technical and advisory assistance for curbing the drug trade and money laundering through its northwestern border region.[264]

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[258] Kalbhushan Yadav has also confessed of managing and setting up terrorist networks in Baluchistan and Karachi. For details, see : *Govt Airs Video of Indian Spy Admitting Involvement In Balochistan Insurgency*, DAWN.COM (Mar. 29, 2016), https://www.dawn.com/news/1248669.

[259] SYED ALI SHAH, *Arrested "RAW agent" trained separatists to target Pakistani ports: security official*, DAWN.COM (Mar. 27, 2016), http://www.dawn.com/news/1248254.

[260] APP, *Transcript of RAW agent Kulbhushan's confessional statement*, DAWN.COM (Mar. 30, 2016), http://www.dawn.com/news/1248786.

[261] *See* Financing of such a terrorist network also coincides with money laundering, for instance, as explained by: PHILIP PURPURA, TERRORISM AND HOMELAND SECURITY: AN INTRODUCTION WITH APPLICATIONS 147 (2011).

[262] *See* ALEX J. BELLAMY, RICHARD DEVETAK, ROLAND BLEIKER & SARA E. DAVIES, SECURITY AND THE WAR ON TERROR 186 (2007).

[263] For instance, see : KIMYET TUNCA CLIYURT & SAMUEL O. IDOWU, EMERGING FRAUD: FRAUD CASES FROM EMERGING ECONOMIES 94 (2012).

[264] *Drugs & Precursors Identification Training for ANF & Pakistan Customs Officials*, UNODOC (Jul. 28, 2016), https://www.unodc.org/pakistan/en/drugs-and-precursors-identification-training-for-

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Moreover, Pakistan also has a cooperative relation with INTERPOL[265] and can approach it for the arrest of any serious criminal who has escaped its law enforcement agencies but is pursuing criminal activities from a foreign land, or conversely INTERPOL can also inform Pakistan of the activities of a Pakistani person who is suspected to be involved in money laundering.[266]

As a result of legislation over the last ten years from Pakistan's parliament designed to combat money laundering, drug manufacturing and trading, and corruption, the international A.M.L. organizations have taken Pakistan off the list of countries that have a high prevalence of money laundering and drug trafficking.[267] This has also given rise to a chance of establishing cooperation with international A.M.L. organizations with renewed vigor to combat money laundering and related crimes.[268]

4.4. PROMINENT CASES OF MONEY LAUNDERING IN PAKISTAN

Some prominent cases of money laundering have been reported over the last decade, and those occurring in Pakistan are mentioned below.

4.4.1. THE CASE OF THE KHANANI AND KALIA FOREIGN EXCHANGE COMPANY

The Khanani and Kalia Company, in Pakistan, operated foreign currency exchange and was involved in money laundering.[269] Javed Khanani and Munaf Kalia were arrested and handed over to the F.I.A.[270] Both were found guilty of

anf-and-pakistan-customs-officials.html.

[265] INTERPOL is an international organization that facilitates intergovernmental police cooperation. For details, *see*: HOSSEIN BIDGOLI, HANDBOOK OF INFORMATION SECURITY, INFORMATION WARFARE, SOCIAL, LEGAL, AND INTERNATIONAL ISSUES AND SECURITY FOUNDATIONS 205 (2006).

[266] For instance, INTERPOL informed Pakistan about Benazir Bhutto and Asif Zardari regarding their alleged money laundering back in 2007. For details, see: NAFISA HOODBHOY, ABOARD THE DEMOCRACY TRAIN: A JOURNEY THROUGH PAKISTAN'S LAST DECADE OF DEMOCRACY (2011).

[267] *Pakistan has effective anti-money laundering laws: SBP*, THE NEWS INTERNATIONAL (Nov. 16, 2009), https://www.thenews.com.pk/print/15696-pakistan-has-effective-anti-money-laundering-laws-sbp#.

[268] For instance, see: The UNODC and FIA stand committed to curb human trafficking and migrant smuggling in extended partnership with police and civil society (UNODC, 2015).

[269] KHURRAM HUSSAIN, *Khanani pleads guilty to money laundering in U.S. court*, DAWN.COM (Nov. 7, 2016), http://www.dawn.com/news/1294812.

[270] Federal Investigation Agency, Pakistan.

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illegally transferring around $10 billion out of Pakistan[271] and were charged according to the law by the F.I.A. upon the completion of investigations.[272] U.S. authorities also charged both with involvement in money laundering in United States and offshore regions.[273]

4.4.2. THE CASH SMUGGLING CASE OF AYYAN ALI

The Pakistani model Ayyan Ali was arrested at Islamabad Airport when U.S.$506,000 were found in her bag, which she was reported to be taking to Dubai.[274] This amount is far higher than the maximum cash limit allowed to be taken out of Pakistan, which was set at $10,000 and $60,000 a year.[275] The amount that Ali had was ten times higher than that.

Legal action was taken against Ali, who was immediately sent to Adiala jail. Investigations were also held; however, Ali was granted bail[276] and was released from jail after paying heavy fines of around 50.5 million[277] (5.5 crore) Pakistani rupees[278] for her violation of Pakistan's A.M.L. laws. As a punishment, her name was also added to the exit control list to prevent her from traveling again outside the country.[279]

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[271] FARAZ KHAN, *Money Laundering Scam Worth $10 billion*, DEFENCE.PK (Nov. 10, 2008), http://defence.pk/threads/money-laundering-scam-worth-10bn.16074.
[272] ZAIB HUSSAIN, *FIA Nominates Javed Khanani in Money Laundering Case*, THE NEWS INTERNATIONAL (Jan. 31, 2015), https://www.thenews.com.pk/print/21394-fia-nominates-javed-khanani-in-money-laundering-case.
[273] ANWAR IQBAL, *Khanani group launders billions of dollars: U.S. report*, DAWN.COM (Mar. 4, 2017), https://www.dawn.com/news/1318333.
[274] HASEEB BHATTI, *Ayyan indicated in currency smuggling case*, DAWN.COM (Nov. 21, 2015), http://www.dawn.com/news/1220779 [Hereinafter: Bhatti].
[275] MASHHUD, *Revised currency carrying limits: SBP seeks FBR's help for assistance*, CUSTOMNEWS.PK (Sept. 10, 2015), http://customnews.pk/2015/09/10/revised-currency-carrying-limits-sbp-seeks-fbrs-help-for-assistance.
[276] BHATTI, *supra* note 274.
[277] *Ayyan fined Rs. 50.5m by Customs Court*, THE NEWS INTERNATIONAL (Apr. 6, 2016), https://www.thenews.com.pk/print/110693-Ayyan-fined-Rs505m-by-Customs-Court.
[278] *Customs court fines Ayyan Ali Rs. 5.5 crore*, ARY NEWS (Apr. 5, 2016), http://arynews.tv/en/customs-court-i-rs-5-5-crore.
[279] JAWAD SHOAIB, *Ayyan Ali's Name Remains on Exit Control List Despite SHC's order*, GEO.TV (Feb. 20, 2017), https://www.geo.tv/latest/131719-Ayyan-Alis-remains-on-Exit-Control-List-despite-SHCs-order.

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4.5. A.M.L. LEGISLATION IN PAKISTAN

Although a very thorough body of legislation has already been made for curbing money laundering, its effectiveness is lost when law enforcement authorities do not put behind bars those money launderers who have political power or enough money to bribe law enforcement agencies' officials. This selective approach keeps the seed of corruption and money laundering alive. Similarly, the government can implement A.M.L. laws strictly to punish its opponents but it never repeats the same procedure against its own political party members. Nonetheless, the most prominent legislation made so far against money laundering includes the following:[280]

- Anti-Money Laundering Ordinance 2007
- Anti-Money Laundering Act 2010
- Anti-Money Laundering Rules 2010
- Anti-Money Laundering Regulations 2010
- Amendments to the A.M.L. Act 2010

All of these pieces of legislation have criminalized money laundering and have given the state the power to arrest and detain anyone who pursues this crime. Jurisdictions and validations of Acts have also been defined, along with the relevant procedures and conditions. In this regard, offenses by individuals, as well as by organizations, have been added to the same category.[281]

4.6. EFFECTS OF A.M.L. LEGISLATION IN PAKISTAN

The effects have not been profound, though they have been enough to demonstrate that law enforcement agencies have taken measures to curb money laundering in Pakistan. For instance, the cases of Ayyan Ali, Dr. Asim, etc. are considered to have been major cases of offenses under the A.M.L. Acts.

[280] For details, *see* Anti-Money Laundering Laws (EXECUTIVE UPDATING SERVICE, 2016).

[281] *Id. For details,* see *the* Anti-Money Laundering Act 2010 passed by the Senate of Pakistan, as Amended up to February 2016, at: http://www.senate.gov.pk/uploads/documents/1363266009_767.pdf; *See also* A Bill to amend A.M.L. Act 2010, as Passed by the National Assembly of Pakistan, http://www.na.gov.pk/uploads/documents/1449207682_201.pdf. These statutes provide the basis of criminalization of money laundering in Pakistan. Moreover, these laws also govern the relevant law enforcement agencies in pursuing their A.M.L. activities.

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Recently, the Supreme Court of Pakistan has accepted the hearings against Prime Minister Nawaz Sharif for the charges of buying offshore property with laundered money. Such cases, if decided judiciously, can pave the way for the strict implementation of A.M.L. laws in Pakistan, which are still deficient in terms of their effective implementation.

5. CONCLUSION

Money laundering has been recognized as a major crime at the international level. Terrorists, drug traffickers, smugglers, black money owners, etc. use different money laundering methods to finance their activities, to traffic drugs, and to clean their illegitimately earned assets.Whichever method is implemented, the three steps of money laundering—placement, layering, and integration of funds—take place.[282] Although A.M.L. organizations in all countries have formulated certain mechanisms, rules, and policies for preventing and curbing money laundering,[283] these policies have been insufficient, whose magnitude has increased to up to billions of U.S. dollars at the international level.[284]

Money laundering causes negative effects to the economy, such as devaluing capital, lowering the growth rate, affecting interest rates and the C.P.I., causing inflation, and defaming financial institutions, which leads to curbing opportunities for domestic and foreign direct investment.[285] In addition, the social costs of money laundering are of an adverse nature as it can result in providing safe havens to criminals, i.e., the drug traffickers, terrorists, and other criminals who are benefitting from laundering cash.[286] The primary reasons for the social costs of money laundering is found in the fact

[282] Jerome Bjelopera & Kristin Finklea. Organized Crime: An Evolving Challenge for U.S. Law Enforcement, 14 (CONGRESSIONAL RESEARCH SERVICE, 2010). JEROME BJELOPERA & KRISTIN FINKLEA, CONG. RESEARCH SERV., R41547, ORGANIZED CRIME: AN EVOLVING CHALLENGE FOR U.S. LAW ENFORCEMENT 14 (2010).
[283] *See* LESLIE HOLMES, TERRORISM, ORGANISED CRIME AND CORRUPTION: NETWORKS AND LINKAGES (2007).
[284] JOSEPH J. NORTON & GEORGE WALKER, BANKS: FRAUD AND CRIME, 203 (2nd ed. 2013).
[285] BRENT BARTLETT, *The Negative Effects of Money Laundering on Economic Development*, ASIAN DEVELOPMENT BANK (May, 2002), https://waleolusi.files.wordpress.com/2013/05/the-negative-effects-of-money-laundering-on-econom.pdf.
[286] US FEDERAL FINANCIAL INSTITUTIONS EXAMINATION COUNCIL, BANK SECRECY ACT/ANTI- MONEY LAUNDERING EXAMINATION MANUAL 8 (2014).
See also U.S. Department of Justice, supra note 107, at 8.

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that this crime is entwined with other serious crimes, i.e., tax evasion, smuggling, whitening of black money, corruption, terrorist financing, and trafficking of illicit drugs and arms.[287] All of these crimes can cause deep adverse effects on the socioeconomic landscape of a society; furthermore, these crimes are considered among the main channels of money laundering, both in Pakistan and globally, as set out above. Therefore, it is essential for law enforcement agencies to curb the crime of money laundering by foiling the channels of money laundering and the tactics that criminals use for laundering cash.

For this purpose, law enforcement agencies need to devise effective strategies and mechanisms to increase cooperation at the domestic, regional, and international level to keep track of the activities that are directly or indirectly linked to money laundering. A continual and strict security on porous international borders and at airports will prevent smugglers and money launderers from moving cash from one region to another. Furthermore, by keeping a strict check on wire transfers and other methods of currency transfers, financial institutions can also play their role in tracking laundered money as well as the sources of the money, and consequently report any suspicious money transfer to the security agencies.[288]

In addition, tax authorities need to devise thorough and investigative auditing strategies in order to keep track of elites' incomes, so that no one can launder cash to avoid taxes. For this purpose, tax revenue departments should also be made independent and sufficiently powerful so that they may not be bribed or influenced politically by any powerful elite.[289] Furthermore, corruption and bribery are other problems that accompany money laundering,[290] because a corrupt person will prefer to hide money acquired

[287] *Id.*

[288] For instance, the Bank Secrecy Act in the U.S. makes it obligatory for financial institutions, including all private- and public-sector banks, to keep track of all suspicious cash transactions in order to trace down the sources of money laundering. *For details, see*: U.S. CONGRESS, PUBLIC LAW 105–310 (1998).

[289] The independence and strength of tax authorities are essential, otherwise elites can avoid taxes by hiding their incomes and sources of their earnings, which leads to money laundering. For details, see: Waber, *supra* note 14, at 21 . In addition, to know about the effects of weakness of tax authorities on money laundering, see MARY ALICE YOUNG, BANKING SECRECY AND OFFSHORE FINANCIAL CENTERS: MONEY LAUNDERING AND OFFSHORE BANKING 12 (2013).

[290] For a detailed impact of money laundering in promoting bribery and corruption, see BRIGITTE UNGER & ELENA MADALINA BUSUIOC, THE SCALE AND IMPACTS OF MONEY LAUNDERING 148 (2007).

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from bribes or corruption to avoid being tracked and penalized by law enforcement authorities.[291]

[291] For details, see BEARE, s*upra* note 95, at 37. To know more about the relationship between corruption and money laundering, see BRUCE ZAGARIS, INTERNATIONAL WHITE COLLAR CRIME: CASES AND MATERIALS 138 (2010). *See also* NORMAN MUGARURA, THE GLOBAL ANTI-MONEY LAUNDERING REGULATORY LANDSCAPE IN LESS DEVELOPED COUNTRIES 124, 144 (2016).

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Enforcement of Arbitral Awards Against a State-Owned Entity: A Tale, Two Jurisdictions

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ABSTRACT: When a private party enter into arbitration with a State Owned Enterprise (S.O.E.), there always a concern as to how the arbitral award might be enforced. It becomes even more worry some if the assets of the S.O.E. are mainly located in its own country or in a country, which practices absolute immunity principle and treats S.O.Es as part of a State. Such practice creates an uncertainty for the private parties who are doing businesses with S.O.Es. On a practical side it is also well known that S.O.Es are big market player as buyer or seller and therefore they cannot be ignored at least in commercial sense. This paper analyses the two distinctive approaches adopted by courts in the U.K. and in Hong Kong on a similar set of facts in which the same group of S.O.Es were involved. As both Hong Kong and the U.K. are part of the same common law tradition, this paper also attempts to highlight that courts are now ready to see S.O.Es as a pure commercial entity rather that as an instrumentalities of a State so far as enforcement of arbitral awards are concerned.

KEYWORDS: *Enforcement of Awards; Sovereign Immunity and Enforcement of Awards; Effect of Absolute and Restrictive Sovereign Immunity on of Awards; Enforcement Against SOEs, Treatment of State Assests and SOEs Assets for Enforcement of Awards.*

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1. INTRODUCTION

When a private party enter into arbitration with a State Owned Enterprise (S.O.E.), there always a concern as to how the arbitral award might be enforced. It becomes even more worry some if the assets of the S.O.E. are mainly located in its own country or in a country, which practices absolute immunity principle and treats S.O.Es as part of a State. Such practice creates an uncertainty for the private parties who are doing businesses with S.O.Es. On a practical side it is also well known that S.O.Es are big market player as buyer or seller and therefore they cannot be ignored at least in commercial sense. In recent Transpacific Partnership Agreement (T.P.P.) an attempt is made to control this unruly horse, S.O.Es, though not from commercial arbitration point of view.[1] This paper analyses the two distinctive approaches adopted by courts in the U.K. and in Hong Kong on a similar set of facts in which the same group of S.O.Es were involved. As both Hong Kong and the U.K. are part of the same common law tradition, this paper also attempts to highlight that courts are now ready to see S.O.Es as a pure commercial entity rather that as an instrumentalities of a State so far as enforcement of arbitral awards are concerned.

2. WORLDWIDE ENFORCEMENT PROCEEDINGS BY F.G. HEMISPHERE

F.G. Hemisphere, a Delaware company, took out court proceedings in various jurisdictions to enforce the two International Chamber of Commerce (hereinafter I.C.C.) arbitral awards against the Democratic Republic of Congo (hereinafter D.R.C.). However, F.G. Hemisphere was not a party to the original

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[1] *See* Sean Miner, *Comments on State-Owned Enterprises*, *in* 2 ASSESSING TRANSPACIFIC PARTNERSHIP-INNOVATIONS IN TRADING RULES, 91-100 (Jeffrey J.Schott & Cathleen Cimino-Isaacs eds., 2016).

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arbitral proceedings under which the awards were made. The arbitration agreement was between Energoinvest, a Yugoslavian company and the D.R.C. In the 1980s, Energoinvest had agreed to construct a hydro-electric facility and high tension electric lines in the D.R.C. The D.R.C. and the D.R.C.'s State Owned Enterprise (hereinafter S.O.E.), *Société Nationale d'Electricité* (hereinafter S.N.E.) entered into credit agreements with Energoinvest to finance the works. It was these credit agreements that contained I.C.C. arbitration clauses. The works were completed but the D.R.C. and S.N.E. defaulted on their payment obligations, despite revision and rescheduling. Energoinvest then instituted arbitral proceedings against the D.R.C. in Switzerland and France. Two awards were rendered on 30th April 2003 by the respective arbitral tribunals in favour of Energoinvest against the D.R.C. and S.N.E. for US$11,725,000 and US$22,525,000 respectively plus interest.

F.G. Hemisphere then entered the picture as a "vulture fund". Vulture funds have been opportunistically profiting from the financial crisis that has been brewing in the past few years. They are particularly active in Africa, Latin America and now Europe. This lucrative enterprise involves the purchase of debts from distressed entities at large discounts.[2] This helps ease the burden of the assignor of the debt because at least part of the outstanding debt has been repaid by the vulture fund. The vulture funds then seek to enforce the purchased debts at their full value against the debtors' assets in different jurisdictions. F.G. Hemisphere can thus be labelled as such a "vulture fund".

3. F.G. HEMISPHERE FROM JERSEY TO THE U.K.

3.1. TARGETED ASSETS

One of the proceedings instituted by F.G. Hemisphere was in Jersey, a British crown dependency. F.G. Hemisphere claimed that the D.R.C. had assets in

[2] The actions of Vulture Funds have been criticized widely which can be summed up in the words of U.N. independent expert on foreign debt and human rights as " It is illogical to grant debt relief to poor countries while at the same time allowing vulture funds to litigate against these countries and thereby dilute the gains from debt relief". *See* JUBILEE AUSTRALIA, *Briefing Paper: Vulture Fund* (Jun. 2011), http://www.jubileeaustralia.org/_literature_87200/Briefing_Paper_-_Preying_on_the_Poor_(2011).

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Jersey, which it could execute the outstanding amount of the awards against. The targeted assets were the 20% shareholding held by *La Générale des Carrières et des Mines* (hereinafter *Gécamines*), an S.O.E. of the D.R.C., in a joint venture mining company called *Groupement pour le traitment du Terril de Lumumbashi* Ltd (hereinafter G.T.L.).[3] Also targeted was the right of *Gécamines* to receive certain payments due to *Gécamines* by G.T.L. in respect of the supply of cobalt and copper-bearing slag.[4] F.G. Hemisphere accordingly argued that *Gécamines* was an organ of the state and so its assets could be equated with those of the D.R.C. in execution of the awards. *Gécamines*, on the other hand, argued that it was an entity wholly independent of the D.R.C. and it could not be held liable for the debts of the D.R.C.

3.2. RULING BY THE ROYAL COURT

The Royal Court of Jersey found on the facts that *Gécamines* was an organ of the D.R.C.[5] Therefore, it held that the assets of *Gécamines* could be equated with those of the D.R.C. and *Gécamines* could be held liable for the debts of the D.R.C. In determining whether *Gécamines* was an organ of the D.R.C., the Royal Court applied Lord Denning's two-limb test as set out in the Trendtex case[6] and considered (i) whether there was governmental control over *Gécamines* and (ii) whether *Gécamines* exercised governmental functions.[7]

In reaching its conclusion, the Royal Court examined (i) *Gécamines*' constitutional position and (ii) the occasions on which the D.R.C. took the assets of *Gécamines* for its own use without compensation. The Royal Court considered two main factors as supporting F.G. Hemisphere's contention that *Gécamines* was an organ of the state. First, the Royal Court was of the view that the review instigated by the D.R.C. of mining contracts since 2007 and the recommendations made by the D.R.C. for renegotiation of the mining contracts

[3] *See F.G. Hemisphere Associates LLC v. The Democratic Republic of Congo and La Générale des Carrières et des Mines* [2010] JRC 195, para. 6 (hereafter referred to as the 'Royal Court judgment').
[4] *Id*.
[5] *Id.* , paras. 140, 194.
[6] *See Trendtex Trading Corp v. Central Bank of Nigeria* [1977] 1 QB 529, 560C-D.
[7] *See supra* note 3, para. 16.

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left little room for departure by *Gécamines*.[8] The renegotiated mining contracts required private sector partners to pay substantial or substantially increased premiums in order to enter into a joint venture with *Gécamines* to exploit mining rights in the D.R.C.[9] Under the renegotiated mining contracts, *Gécamines*' stance was that it was the rightful owner of these "entry fees", which constituted "part of its assets".[10] Instead of requiring all the "entry fees" to be remitted to the State Treasury, the D.R.C. agreed to have half remitted to the state and the other half to *Gécamines*.[11] The Royal Court took the unsuccessful bargaining by *Gécamines* with the D.R.C. in respect of its claim to the "entry fees" into account in concluding that the D.R.C. controlled *Gécamines*.[12]

Secondly, the Royal Court relied on its finding that *Gécamines* was used "as an instrument for the implementation of policies and projects of national importance".[13] The project concerned was a massive inter-state infrastructure project, which was to be funded by a Chinese consortium.[14] A joint venture company, Sicomines, was formed by *Gécamines* and the Chinese consortium to exploit mining rights in the D.R.C. However, revenue from Sicomines was to fund not *Gécamines*' activities, but the D.R.C.'s infrastructure project. The Royal Court saw the mining rights as being mortgaged by *Gécamines* as security for loan finance by the Chinese consortium for both the infrastructure project and the Sicomines project.[15] The Royal Court was of the opinion that were it not for the "overall direction and control" of the D.R.C., this project would not have been possible[16] and *Gécamines* would not have been able to afford the exploitation of these mining rights. The Chinese consortium was also required to pay "entry fees" of US$350 million under the Sicomines project. Over 70% of the "entry fees" were designated to go to the D.R.C. and the remaining to

[8] *Supra* note 3, para. 101.
[9] *Supra* note 3, para. 103.
[10] *Supra* note 3, para. 105.
[11] *Supra* note 3, para. 106.
[12] *Supra* note 3, paras. 103, 105.
[13] *Supra* note 3, paras. 109, 132.
[14] The Chinese consortium comprised the Export-Import Bank of China, China Railway and Sinohydro.
[15] *Supra* note 3, para. 130.
[16] *Supra* note 3, para. 129.

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Gécamines.[17] Again, the Royal Court viewed this as supporting F.G. Hemisphere's contention of "the Government making free with *Gécamines*" revenue".[18]

Based on these two main factors, the Royal Court concluded that the two limbs of the Trendtex test were satisfied, in that *Gécamines* was under government control and carried out governmental functions. The Royal Court stated, using rather strong language:[19]

> The picture that emerges strongly in *Gécamines*' case is that of an entity which has in many ways been dressed in the garb of an independent body, but whose formal constitution counts for little or nothing when the state so chooses: a creature that has sometimes been allowed a considerable autonomy but which, when it matters, can be and is unceremoniously subjected to the controlling will of the state.

As such, the Royal Court held that *Gécamines* could be regarded as an organ of the state and the assets of *Gécamines* were liable to execution in satisfaction or part satisfaction of the awards.[20]

3.3. RULING BY THE ROYAL COURT OF APPEAL

Gécamines then appealed to the Royal Court of Appeal, which affirmed the findings of the lower court on similar grounds.[21] Going further than the Royal Court, the Court of Appeal was of the view that governmental control and the exercise of government functions alone could not suffice to regard an entity as an organ of the state. It was necessary that "the principal functions and activities of the entity are properly to be viewed as governmental", but there need not be "any actual sovereign acts".[22] The Court of Appeal was satisfied

[17] *Supra* note 3, para. 120. US$250 million was to go to the State Treasury of the D.R.C. and the balance to *Gécamines.*
[18] *Supra* note 3, para. 109.
[19] *Supra* note 3,para. 141.
[20] *Supra* note 3, para. 195.
[21] With Pleming J. dissenting.
[22] *See F.G. Hemisphere Associates LLC v. The Democratic Republic of Congo and La Générale des Carrières et des Mines* [2011] JCA 141, paras. 71, 78.

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that *Gécamines* had met this threshold and its assets could be equated with those of the D.R.C.

3.4. RULING BY THE PRIVY COUNCIL

This case then went up to the Privy Council, the highest court for British crown dependencies. In *La Générale des Carrières et des Mines v. F.G. Hemisphere Associates LLC* (hereinafter the *Gécamines* case),[23] the Privy Council overturned the decision of the Royal Court of Appeal. It held that *Gécamines* was not an organ of the state but a separate entity. As such, the assets of *Gécamines* could not be equated with those of the D.R.C. and it could not be held liable for the debts of the D.R.C.

The Privy Council considered that the Royal Court and the Royal Court of Appeal incorrectly formulated and applied the *Trendtex* test in determining whether a S.O.E. can be held liable for state debts.[24] The Board was of the view that if constitutional and/or factual control alone sufficed, almost any state trading corporation may then be liable for state debts.[25] The Board also pointed out that this situation would be inconsistent with the common law and the spirit of the United Kingdom's State Immunity Act 1978 (hereinafter the 1978 Act),[26] which took up the approach of the European Convention on State Immunity.[27] The Board quoted section 14 of the 1978 Act, section 14(1) of which provides that immunity does not apply "to any entity (hereafter referred to as a "separate entity") which is distinct from the executive organs of the government of the State and capable of suing and being sued." Section 14(2) goes on to list the only situations in which such a separate entity could be immune in the courts of the United Kingdom. This, the Board stated, showed that the 1978 Act was "at pains to recognise the separateness and distinctness of state-owned corporations, notwithstanding they may have been entrusted

[23] [2012] UKPC 27; Privy Council Appeal No 0061 of 2011, 17 July 2012.
[24] *Id.*, para. 51.
[25] *Id.*, para. 19.
[26] State Immunity Act, 1978, c. 33 (U.K.).
[27] Council of Europe, European Convention on State Immunity, May 16th, 1972, ETS No. 074, 1495 U.N.T.S. 182. The 1978 Act was extended to Jersey by the State Immunity (Jersey) Order 1985.

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with public functions including activities involving the exercise of sovereign authority."[28]

The Board considered the traditional Saloman principle[29] that a company has its own legal personality and the circumstances in which the corporate veil could be pierced.[30] However, the Board made it clear that a body could be regarded as an organ of the state despite its separate legal personality.[31] This meant that a separate legal personality was not conclusive as to whether an entity was to be regarded as an organ of the state.[32] Although relevant, nor were constitutional and factual control and the exercise of sovereign functions without more conclusive.[33] It follows from this statement that the Board regarded the *Trendtex* test as insufficient or too simple a test in determining whether *Gécamines* was an organ of the D.R.C. The Board went on to state:[34]

> . . . . Where a separate juridical entity is formed by the State for what are on the face of its commercial or industrial purposes, with its own management and budget, the strong presumption is that its separate corporate status should be respected, and that it and the State forming it should not have to bear each other's liabilities.

The Board set a rather high threshold for the assets of a state-owned entity to be equated with those of the state. Extreme circumstances were required. To displace the presumption, the affairs of the entity and the State had to be "so closely intertwined and confused that the entity could not properly be regarded for any significant purpose as distinct from the State and vice versa."[35] The Board then stated an exception: "circumstances in which the State has so interfered with or behaved towards a state-owned entity that it would be appropriate to look through or past the entity to the State, lifting the veil of incorporation."[36] The Board added that merely because a state's conduct makes

[28] *See supra* note 22, para. 19.
[29] *Salomon v. A. Salomon & Co Ltd* [1897] AC 22.
[30] The Board accepted that a court is only justified to pierce the corporate veil if there is control by the wrongdoer *and* some impropriety linked to the use of the company structure to avoid or conceal liability*see Ben Hasham v. Ali Shayif* [2008] EWHC 2380 (Fam), paras. 159-163.
[31] *See supra* note 22, para. 25.
[32] *See supra* note 22, para. 29.
[33] *See supra* note 22, para. 29.
[34] *See supra* note 22, para. 29.
[35] *See supra* note 22, para. 29.
[36] *See supra* note 22, para. 30.

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it appropriate to lift the corporate veil to enable a creditor of a S.O.E. to look to the state does not mean the creditor of a state could look to the S.O.E.[37] In respect of when the corporate veil could be lifted, the Board further considered that "the international element may raise different considerations . . . . from those that would arise under purely domestic circumstances."[38] Ultimately, the Board decided, "an overall judgment is required as to whether "the required degree of separation" is present".[39] In other words, whether the entity was an organ of the state did not depend on a single factor, but on a consideration of all the relevant circumstances.[40]

The Board pointed out that the Royal Court and the Royal Court of Appeal did not consider as important whether or not *Gécamines* was fulfilling a sovereign function (acta jure imperii).[41] The Board further regarded the Royal Court of Appeal as having adopted a very broad concept of government.[42] By this, the Royal Court of Appeal was stated to have unjustifiably considered whether the functions, which could otherwise be viewed as ordinary trading activities, were ancillary to a principal function of the government or functions like carrying out government policies.[43] The Board was of the view that the Royal Court of Appeal diluted the approach to sovereign activity as indicated by Lord Wilberforce in Il Congresso del Partido: that mere governmental purpose or motive did not convert a commercial act into a sovereign act and that it was necessary to consider the whole context of the activity to see whether it was sovereign in nature.[44]

On an examination of the constitution and activities of *Gécamines*, the Board decided that *Gécamines* was not an organ of the D.R.C. and F.G. Hemisphere could not look to its assets for enforcement. There was also no justification to lift the corporate veil.[45] The fact that *Gécamines* was controlled by the D.R.C. was not surprising to the Board, because, after all, it was a

[37] *See supra* note 22, para. 30.
[38] *See supra* note 22, para. 42.
[39] *See supra* note 22, para. 34.
[40] *See* Andrew Dickinson, Rae Lindsay & James P. Loonam, State Immunity, Selected Materials and Commentary (2004).
[41] *See supra* note 22, paras. 44, 45.
[42] *See supra* note 22, para. 45.
[43] *See supra* note 28, paras. 45, 47.
[44] *See supra* note 22, paras. 46, 47.
[45] *See supra* note 22, para. 77.

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S.O.E.[46] Nor was the fact that *Gécamines* assisted, promoted and advanced development, prosperity and economic welfare and carried out such government policies. The reasoning of the Board was that such features were "of the essence of many state-controlled corporations' functions' and did not make them part of the state."[47] The Board also addressed the two principal areas relied on by the Royal Court as supporting F.G. Hemisphere's case: (i) the mining review instigated by the D.R.C. and the treatment of the "entry fees" and (ii) the Sicomines transaction.

In relation to the review instigated by the D.R.C. of the mining contracts, the Board was of the view that *Gécamines*' position was one of insisting on its right to set-off the "entry fees" paid to the D.R.C. against its tax and other liabilities.[48] This suggested that *Gécamines* considered itself an entity with interests separate from the D.R.C. It was:[49]

> A real and functioning corporate entity, having substantial assets and a substantial business including interests in over thirty joint ventures with outside concerns. It had its own budget and accounting, its own borrowings, its own debts and tax and other liabilities and its own differences with government departments.

As for the Sicomines transaction, the Board disagreed with the Royal Court that *Gécamines* was "unceremoniously subjected to the controlling will of the state" because not only did the D.R.C. contribute to the transaction, *Gécamines* derived real commercial benefits from the transaction.[50] The Board concluded that neither of the two areas relied on by the Royal Court went to show that *Gécamines* was exercising sovereign functions.

4. F.G. HEMISPHERE IN HONG KONG

[46] *See supra* note 22, para. 43.
[47] *See supra* note 22, paras. 44, 48, 54.
[48] *See supra* note 22, paras. 61, 68.
[49] *See supra* note 22, para. 70.
[50] *See supra* note 22, para. 69. These commercial benefits are, as pointed out by the Board, the US$50 million loan made to *Gécamines* by the Chinese consortium, the US$100 million premium (part of the "entry fees" to be paid by the Chinese consortium), the US$32 million loan made to *Gécamines* by the Chinese consortium to enable it to subscribe for shares in Sicomines and *Gécamines*' 30% shareholding in Sicomines.

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F.G. Hemisphere was also involved in a spate of litigation in Hong Kong. This time, the assets targeted for execution of the awards against the D.R.C. were the part of the "entry fees" to be paid by the Chinese consortium to the D.R.C. under the Sicomines transaction.[51] The case went up all the way to the Court of Final Appeal.[52] The two main issues before the Hong Kong courts in this case were whether (i) the doctrine of restrictive immunity or the doctrine of absolute immunity applied to Hong Kong post-handover and (ii) whether the D.R.C. had waived any immunity by virtue of agreeing to the application of the I.C.C. Rules.[53] This paper does not aim to go into a detailed discussion of the issues.[54] Instead, the focus is on how the courts viewed the "entry fees" under the Sicomines transaction for the purposes of execution of the awards.

The Court of Final Appeal, however, did not go to the issue of execution against the "entry fees" because it had already held that the D.R.C. was absolutely immune from proceedings. The majority opinion was that following the handover in 1997, Hong Kong followed the doctrine of absolute immunity, consistent with the People's Republic of China (hereinafter P.R.C.).[55] It also held that there had been no waiver of immunity by the D.R.C. The judgment of the Court of Final Appeal was provisional as the majority was of the view that the Court was obliged to seek an interpretation from the Standing Committee of the National People's Congress (hereinafter NN.P.C.S.C.) of the Basic Law provisions engaged pursuant to Article 158(3) of the Basic Law. Upon receiving the sought interpretation from the N.P.C.S.C., the Court of Final Appeal

[51] Then believed to be US$221 million (as opposed to the US$250 million figure stated in the *Gécamines* case). *See F.G. Hemisphere Associates LLC v. Democratic Republic of Congo & Ors* [2009] 1 HKC 111, para 4 (Hong Kong Court of First Instance) (hereafter referred to as the 'C.F.I. judgment').
[52] *See Democratic Republic of Congo & Ors v. F.G. Hemisphere Associates LLC* FACV Nos. 5,6,7 of 2010, 8th June 2011 (Hong Kong Court of Final Appeal) (hereafter referred to as the 'C.F.A. judgment').
[53] *See* Int'l Chamber of Commerce [ICC], International Chamber of Commerce Arbitration Rules 1998 art. 28, para. 6, which governed the 2 ICC arbitrations, provides: 'Every Award shall be binding on the parties. By submitting the dispute to arbitration under these Rules, the parties undertake to carry out any Award without delay and shall be deemed to have waived their right to any form of recourse insofar as such waiver can validly be made.'
[54] These have been discussed in detail see Rajesh Sharma, *Enforcement of Arbitral Awards and Defence of Sovereignty: The Crouching Tiger and the Hidden Dragon*, LAPLAND L. REV., no 1, 2011, at 252.
[55] Application of absolute immunity in Hong Kong by China has been seen negatively from the international arbitration perspective. *See* generally Ashley Bell, *Big Trouble in 'Little China*, 28 J. INT'L ARB. 643-652 (2011). Nicholas A. Brown & James D.A. Lewis, *Game of Thrones: A Narrowing Immunity?*, 30 J. INT'L ARB. 689-700 (2013); Nicholas Pengelley, *Waiver of Sovereign Immunity from Execution: Arbitration is Not Enough*, 26 J. INT'L ARB. 859-872 (2009); TERESA CHEN & ADRIAN LAI, *Lesson Learned From the FG Hemisphere and Huatianlong Case,* ARBITRATION-ICCA.ORG, http://www.arbitration-icca.org/media/4/13523372058325/media11323427644627 06-lessons_learned_from_the_fg_hemisphere_vs_drc_and_huatianlong_case.pdf.

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confirmed its provisional judgment as the interpretation was consistent with it.[56]

However, in the courts below, the issue of execution in relation to the "entry fees" was relevant as they had held that the doctrine of restrictive immunity applied.[57] It was then important for the courts to determine whether the Sicomines transaction was one of a commercial nature such that it fell within the exception to the doctrine of restrictive immunity.[58]

4.1. HIGH COURT OF HONG KONG

In the High Court, Justice Reyes held the view that the Sicomines transaction was not of a commercial nature.[59] First, Justice Reyes considered that the transaction was executed under the umbrella cooperation agreements between the P.R.C. and the D.R.C.[60] The Sicomines transaction was an inter-state one between the P.R.C. and the D.R.C., notwithstanding the fact that the Chinese side entered into the transaction through corporations.[61] The corporations, he noted, were state owned.[62]

Second, His Justice derived from the fact that the Sicomines transaction was "massive and ambitious" that it was not a "routine trading operation" – it could only have been carried out with state backing.[63] His Justice further noted

[56] *Democratic Republic of Congo & Ors v. F.G. Hemisphere Associates LLC* FACV Nos. 5,6,7 of 2010, 8 September 2011 (Hong Kong Court of Final Appeal).
[57] Justice Reyes, in the High Court did not express a definitive view of which doctrine applied. His provisional view was that the common law restrictive immunity approach applied to Hong Kong. It was not necessary for him to conclude on the applicable approach because he held that the Sicomines transaction was not of a commercial nature. Therefore, it fell within the exception to restrictive immunity which meant that whether Hong Kong followed restrictive or absolute immunity, the D.R.C. was immune in either case: *see supra* note 51, paras. 69, 70.
[58] As a general trend if a property of a State-owned enterprise which is kept and used specifically for the fulfillment of sovereign functions or used for sovereign purposes is immune from attachment or execution. See A.F.M. Maniruzzaman, *State Enterprises Arbitration and Sovereign Immunity Issues: A Look at Recent Trends*, DIS. RESOL. J., Aug.-Oct. 2005, at 1-8..*See also* the trend in the context of investment arbitration in Paul Blyschak, *State-Owned Enterprises and International Investment Treaties: When Are State-Owned Entities and Their Investments Protected*, 6 J. INT'L L. AND INT'L REL., no. 2, 2011, at 1-52.
[59] *See supra* note 51, para. 83.
[60] *See supra* note 51, para. 85.
[61] *See supra* note 51, para. 86.
[62] *See supra* note 51, para. 86.
[63] *See supra* note 51, paras. 87, 89.

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that the infrastructure project involved was for "the development of the whole of the D.R.C. for the economic benefit and well-being of its citizens."[64]

Third, Justice Reyes believed that the agreements were not conventional for a trading contract.[65] For instance, there were provisions dealing with tax and customs duties exemptions. Visas and work permits were also assured for expatriate staff in that contract. Justice Reyes opined that these terms could only be stipulated by a state in the exercise of its sovereign power.[66]

Lastly, His Justice was of the view that a state could exact the "entry fees" in consideration of the licence to exploit the D.R.C.'s mineral rights.[67] His Justice concluded that these features were the "hallmarks of the exercise by states of sovereign authority in the interests of their citizens."[68] His Justice held that even if the "entry fees" were an asset of the D.R.C., the D.R.C. could raise immunity from execution because the transaction was not of a commercial nature, and the D.R.C. had not waived its immunity.[69]

4.2. COURT OF APPEAL

Consistent with Justice Reyes' provisional view, the majority in the Court of Appeal held that Hong Kong continued to follow the common law doctrine of restrictive community following the resumption of sovereignty by the P.R.C. in 1997.[70] The Court of Appeal was also of the view that submission to arbitration under the I.C.C. Rules did not amount to a waiver of immunity by the D.R.C.

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[64] *See supra* note 51, para. 88.
[65] *See supra* note 51, para. 90.
[66] *See supra* note 51, para. 90.
[67] *See supra* note 51, para. 91.
[68] *See supra* note 51, para 92.
[69] *See supra* note 51, paras 145, 110, 117, 121. For a critical view of the approach of Justice Reyes taken in regards to the relevant ICC Rules as simply a waiver of the right of challenging an enforcement by D.R.C. and not as waiving the right of immunity from execution see Nicholas Pengelley, *Waiver of Sovereign Immunity from Execution: Arbitration is Not Enough*, 26 J. INT'L ARB 859, 866. For a detailed survey of I.C.C. cases relating to liability of state for its instrumentalities see Eduardo Silva Romero, *Are State Liable for the Conduct of their Instrumentalities: ICC Case Law, in* 4 STATE ENTITIES IN INTERNATIONAL ARBITRATION ,THE INTERNATIONAL ARBITRATION INSTITUTE 31-55 (Emmanuel Gillard & Jennifer Yunan eds., 2008).
[70] [2010] 2 HKC 487, para. 122 (Hong Kong Court of Appeal) (hereafter referred to as the 'C.A. judgment'). With Hon Yeung JA dissenting, para 228.

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However, the Court held that Justice Reyes had applied the wrong test in determining whether the "entry fees" were immune from execution.[71] Counsel for F.G. Hemisphere contended that the correct test was to look at the intended purpose of the assets sought to be attached. The Court of Appeal agreed that Justice Reyes had wrongly made reference to the nature of the Sicomines transaction, which gave rise to the "entry fees" liability.[72] The nature of the underlying acts was relevant to the first stage when immunity from suit is considered,[73] and not at the execution stage. At the execution stage, the correct test was to consider what the intended purpose of the "entry fees" was.[74] If the "entry fees" were to be used for a sovereign or public purpose, they could not be subjected to execution.[75] If they were for purely commercial purposes, the awards could be enforced against such an amount.[76]

The Court of Appeal found that there was evidence suggesting that "entry fees" going to the D.R.C. were to be used for its budget.[77] Subject to further findings of fact, the Court was of the view that this amount was immune from execution as it was for a public purpose.[78] What was interesting was the Court's statement that "the plaintiff has shown a good arguable case for injunctions over the *Gécamines* tranche" because this part of the "entry fees" was intended for a commercial purpose.[79] This goes to show that the Court saw that there was a good arguable case that *Gécamines*' assets could be assimilated with those of the D.R.C. On this issue, the court ordered an "inquiry to determine to what extent, if any, the entry fees . . . . are intended by the D.R.C. for payment to *Gécamines* and, further, whether the amount thus

[71] With Hon Yeung JA dissenting on this point, *Id*, paras. 242, 243.
[72] *See supra* note 70, para. 179.
[73] The relevant acts in this case were those in relation to the entry by the D.R.C. into credit agreements with Energoinvest. Hon Yuen JA therefore rightly stated that Justice Reyes had not considered whether such acts were commercial or sovereign in 'nature' for the purposes of determining whether the D.R.C. was immune from the jurisdiction of Hong Kong courts, under the doctrine of restrictive immunity. Hon Yuen JA was of the view that it was clear that the transactions were commercial in nature as they were financing arrangements. Accordingly, the D.R.C. was not immune from being impleaded in Hong Kong courts under the doctrine of restrictive immunity: *Supra* note 70, paras 268, 269.
[74] *See supra* note 70, para. 179.
[75] *See supra* note 70, paras. 179, 276.
[76] *See supra* note 70, paras. 179, 276.
[77] *See supra* note 70, para. 179.
[78] *See supra* note 70, paras. 179, 276.
[79] *See supra* note 70, paras. 179, 276.

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payable is amenable to or immune from execution".[80] Unfortunately, the Court on this issue did not go any further.

5. THE GÉCAMINES CASE – IS IT BASED ON PRINCIPLE?

It is submitted that the simple way of disposing of the case would have been to determine whether *Gécamines*' assets which were being sought to be attached were for commercial or sovereign purposes. If they were for commercial purposes, these assets would have been available to F.G. Hemisphere for execution of the awards because of the doctrine of restrictive immunity. If they were for sovereign purposes, these assets would have been immune from execution. It is likely that the courts would have arrived at the former conclusion given the extensive operation of *Gécamines* in the commercial arena. F.G. Hemisphere would accordingly have been able to execute the awards against *Gécamines*' assets. Yet the courts in Jersey went a step back to look at whether *Gécamines*' assets could be said to belong to the D.R.C. for the purposes of execution of the awards against the D.R.C. This was crucial to the case because F.G. Hemisphere could not pursue the assets of an entity which was not an organ of the D.R.C. The difficult question then arose as to the applicable principles to determine whether an entity could be held responsible for the state's liability.[81]

This *Trendtex* test was approved in the Kensington case by Cooke J, who stated that the relevant factors to determine whether a body was entitled to immunity from suit could apply to determine whether a particular body could be held liable for the state's debts.[82] Yet the Board considered the test of "governmental control and function" in the *Trendtex* case as inconclusive, albeit relevant. Accordingly, even upon an examination of a S.O.E.'s constitution, powers, duties and activities, a court would not be able to determine conclusively whether or not the S.O.E. is an organ of the state. Based

[80] *See supra* note 70, para. 284.
[81] The debate of this issue is still alive and a survey of various jurisdictions has not shown any conclusive approach. For further discussion, see A.F.M Maniruzzaman, "State Enterprise Arbitration and Sovereign Immunity Issues: A Look at Recent Trends", pp.1-8.
[82] *See Kensington International Limited v. Republic of Congo* [2005] EWHC 2684 (Comm.) paras. 52, 53.

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on the Board's decision, the starting point for a court would be to presume that a S.O.E. is a separate legal entity, because of its separate legal personality. It would be extremely difficult for the court to justify that the S.O.E. is an organ of the state. This would only be possible in the rare circumstances where the affairs of the S.O.E. and the state are "so closely intertwined and confused" that the S.O.E. cannot be regarded for "any significant purpose" as distinct from the state.[83]

In holding that there was a strong presumption that an S.O.E. with its own management and budget was an entity distinct from the state, the Privy Council gave due respect to the tradition Salomon principle. However, the Board has by no means set out clear principles as to when an entity is to be regarded as "distinct" from the state. It is argued here that the *Trendtex* test provides a much more principled approach, or at least a starting point for the courts. In looking into whether an entity exercises governmental function, the purpose that it serves automatically comes into play. If the purpose of the S.O.E. "is to assist, promote and advance the industrial development, prosperity and economic welfare of the area in which it operates", it is carrying out government policy and assumes the position of an organ of the state.[84] This can by all means be through the carrying out of commercial activity, like *Gécamines* was.

However, the Board disapproved of this approach in relation to *Gécamines* and was of the view that it was the overall context that mattered.[85] The very thing that the Board went on to examine in deciding whether or not *Gécamines* was an organ of the state was its constitution and activities. Whether the "overall context" that the Board cited to reach its conclusion that *Gécamines* was not an organ of the state remains unclear. The Royal Court of Jersey and the Royal Court of Appeal had seemingly also considered the "overall context" when one looks to the matters that were raised and

[83] *See supra* note 22, para. 29.
[84] *See supra* note 22, para 53 (Cooke J.).
[85] There has been an argument that sometimes, even where motive and purpose are judged irrelevant to determining the commercial character of an activity, reference has been made to the context in which the activity took place. See Yearbook of the International Law Commission 1999 para. 49, 2 Y.B. Int'l L. Comm'n, A/CN.4/SER.A/1999/Add.l (Part 2), as quoted in A.F.M Maniruzzaman, "State Enterprise Arbitration and Sovereign Immunity Issues: A Look at Recent Trends", p. 3.

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considered. It is difficult to understand why the Board did not value the overwhelming control by the D.R.C. over *Gécamines* and the fact that *Gécamines*' assets originated from the D.R.C.[86] It appears that the Board had simply imposed its own view on the facts, and justified intervention by holding that the lower courts had applied an incorrect test.[87]

6. GÉCAMINES' STATUS CONSIDERED IN HONG KONG

Although the status of *Gécamines* was not a central issue in the Hong Kong courts, F.G. Hemisphere did submit that *Gécamines* was merely an agent or front acting for the D.R.C.[88] such that the entire amount of "entry fees" belonged to D.R.C. However, further findings of fact were necessary for the Hong Kong Court of Appeal to come to a conclusion, so it proceeded on the assumption that the "entry fees" were due to the D.R.C. in deciding whether the D.R.C. was immune.[89]

Even so, it is interesting to note that the Court of Appeal considered there to be an arguable case for injunction over the *Gécamines* tranche of the "entry fees". The Court viewed that this part would have been used by *Gécamines* for commercial purposes and so immunity against execution was not available. His Honourable Justice of Appeal Yuen adopted the factors listed by Justice Reyes to support why he considered it arguable that the "entry fees" were the D.R.C.'s assets.[90] Remarkably, these factors are in line with the considerations that contributed to the Jersey courts' holding that *Gécamines* was an organ of the D.R.C., namely: the Sicomines transaction was made possible only because it was an inter-state one between the D.R.C. and the P.R.C.; [91] the Sicomines transaction was of national importance for the benefit of the public;[92] and the D.R.C. made free use of *Gécamines*' revenue.[93]

[86] *See supra* note 22, para. 54.
[87] *See supra* note 22, para. 51.
[88] *See supra* note 51, para 28; *Supra* note 70, para. 275.
[89] *See supra* note 70, para. 172.
[90] *See supra* note 70, 275.
[91] *See supra* note 51, para. 85; *cf supra* note 3, para. 129.
[92] *See supra* note 51, para. 88; *cf supra* note 3, paras. 109, 132.

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It may be said that the Court of Appeal found it arguable that *Gécamines*' assets could be equated with those of the D.R.C., for it was only then that the *Gécamines* tranche could be subjected to enforcement for D.R.C.'s liability. Of course, one might be stretching this argument too far — just because the Court found it arguable on the facts that the "entry fees" in the *Gécamines* tranche belonged to the D.R.C. does not mean *Gécamines*' entire asset pool can be equated with that of the D.R.C. Pursuing this line of argument would be too narrow approach as the sole consideration taken into account is the Sicomines transaction. Nevertheless, at the very least, the strong similarity in the reasoning of the Jersey courts and the Court of Appeal cannot be overlooked.

7. THE IMPACT OF THE GÉCAMINES CASE ON FUTURE CASES

This being a Privy Council case, it would only be binding on all courts in Commonwealth countries, the U.K.'s overseas territories and British Crown Dependencies. As for the U.K. and Hong Kong, it is likely to be highly persuasive if a question arises as to whether an S.O.E.'s assets can be pursued by the creditors of the state. The courts would have to decide whether the S.O.E.'s assets can be said to belong to the state, in other words, whether the S.O.E. is an organ of the state.[94]

7.1. WHERE THE LIABILITY IS INCURRED BY THE STATE

Creditors may want to go after the assets of an S.O.E. to execute an award made against the state, as in the *Gécamines* case. To justify execution against the assets of an S.O.E., the creditor would seek to argue that the S.O.E. is an organ of the state such that its assets can be equated with those of the state. If the *Gécamines* case is followed in future cases, there would be a strong presumption that an S.O.E. is a separate entity. Extreme circumstances would be required to displace such a presumption. When the S.O.E. is found as a

[93] *See supra* note 51, para. 91; *cf supra* note 3, para. 109.
[94] This paper does not focus on the situation where state-owned enterprises might be a claimant. On this point see generally Mark Feldman, *State-Owned Enterprises as Claimant in International Investment Arbitration*, 31 ICSID REVIEW, no. 1, 2016, at 24-35.

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separate entity and not a sham, its assets cannot be equated with those of the state for the purposes of execution of arbitral awards by creditors. If, considering the overall context, the S.O.E. is found to be an organ of the state, its assets can be equated with those of the state and creditors can go after them. It would then be up to the S.O.E. to raise the defence of immunity from execution. The assets of the S.O.E. may or may not be immune from execution depending on the intended purpose of the assets sought to be attached. If the assets are intended for commercial use, no immunity is available and the creditors can execute their awards against such assets under the doctrine of restrictive immunity. If the assets are for a sovereign or public purpose, they would be immune from execution.

In Hong Kong courts, in the absence of clear waiver of immunity from execution provisions or an unequivocal waiver by the state in the face of the courts, creditors are unable to implead a State in the execution of an award against the state because of the application of the doctrine of absolute immunity.[95] Even if an S.O.E. is found to be an organ of the state, its assets would be absolutely immune from execution. Whether the S.O.E. is a separate entity or an organ of state would produce the same result — one where the creditor cannot pursue the S.O.E.'s assets. It would therefore be unnecessary for a Hong Kong court to consider whether an S.O.E. is an organ of the state where the creditor is seeking to execute an award against a state. Going into an examination of the status of an S.O.E. would merely be academic. This leaves little room for the application of the *Gécamines* case in this context.

7.2. WHERE LIABILITY IS INCURRED BY THE S.O.E.

The converse of the scenario in the *Gécamines* case is where the state's assets are being targeted by a creditor of its S.O.E. This may occur where the S.O.E. is considered insolvent, for example. It is likely that courts would apply the same reasoning to this scenario. The starting point would again be to consider whether there are extreme circumstances which displace the strong presumption that the S.O.E. is a separate entity, or whether the S.O.E. was

[95] *See supra* note 51 and as confirmed in the interpretation of the Basic Law by the N.P.C.S.C.

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simply a sham. If the S.O.E. is found be a separate entity and not a sham, its assets cannot be equated with those of the state. This would mean that the creditors of the S.O.E. will not be able to look to the state's assets for execution. If, considering the overall context, the S.O.E. is found to be an organ of the state, its assets can be equated with those of the state. Then, creditors can go after state assets provided that they are intended for commercial purposes.

Again, the situation in Hong Kong would be different as it follows the doctrine of absolute immunity. Even if an S.O.E. is an organ of the state, both its assets and those of the state are absolutely immune from execution, in the absence of a clear waiver. This is regardless of what purpose the assets sought to be attached serve. If the S.O.E. is a separate entity, a creditor can certainly not seek execution against the assets of the state. The creditor can only seek to execute the award against the assets of the S.O.E., which would have no immunity from suit or execution if it is a separate entity. Again, it is argued that the relevance of the *Gécamines* case with respect to the execution stage is limited in Hong Kong courts. Whether or not a S.O.E. is an organ of the state goes only so far as to determine whether it has immunity from suit or execution against its own assets. Any examination by Hong Kong courts of the S.O.E.'s status for the purposes of execution against state assets would only serve an academic purpose.

8. CONCLUSION

Increasingly, states are using their S.O.Es to enter into transactions with others parties. With the precedent set by the *Gécamines* case, the separate legal personality of S.O.Es is to be respected and they are likely to be considered separate entities, unless there are exceptional circumstances to justify assimilating between them and the state. What this would mean on the one hand is that S.O.Es will be increasingly shielded from the creditors of the state, and on the other, S.O.Es would face a high hurdle in raising the defence of immunity. Conversely, if S.O.Es are presumed to be separate entities, states are less likely to be held responsible for the liabilities of S.O.Es. Overall, this

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provides a holder of an arbitral award with fewer targets for enforcement. The impact of the *Gécamines* case on future similar Hong Kong cases remains to be seen — but it is suggested that it would be limited and would not go beyond determining whether an S.O.E. has immunity from suit.

One might naturally ask whether the Privy Council had underlying policy considerations due to the fact that a vulture fund was involved. After all, F.G. Hemisphere was a vulture fund that spanned several jurisdictions and was aggressively pursuing the full amount of a debt that it had bought at a huge discount.[96] Perhaps the Board had in mind wider equitable considerations, especially since it seemed to have adopted a wholly novel approach to the issue at hand. The interesting question is whether this case would have been decided in the same way were the enforcement proceedings between the original parties to the arbitral agreement.

[96] F.G. Hemisphere also won a case the New South Wales, Australia where the court allowed US$30 million to recover against D.R.C. *See* VANDA CARSON, *Vulture Fund Wins Case Against Cash-strapped Congo,* SMH.COM.AU (Dec. 22, 2010), http://www.smh.com.au/business/vulture-fund-wins-case-against-cashstrapped-congo-20101221-194fj.html. The decision of the court allowing this vulture fund against poor country like D.R.C. was heavily criticized. See James Bai, *Stop Them Circling: Addressing Vulture Fund in Australian Law*, 35 SYDNEY L. REV. 703-730 (2013).

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