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The Exclusion of the Validity of the Contract from the CISG: Does it still Matter?

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Contracts; Fraud; International sales; Mistake; Sale of goods; Treaties; Unconscionability; Validity

Abstract

The United Nations Convention on Contracts for the International Sale of Goods (CISG) was created to provide a uniform sales law that would address the globalisation of world trade and business practices of parties in different contracting states. Despite this notable goal, the CISG excludes from its application highly important questions such as the validity of contract. As of the CISG's 35th birthday, contract validity proves to still be an issue. This article surveys various strategies to remedy the validity gap in the CISG. The article highlights the difficulties associated with a comprehensive approach to the question of contract validity and suggests the coverage of specific issues where the CISG would be augmented by other initiatives as a more feasible option.

Introduction

The United Nations Convention on Contracts for the International Sale of Goods (CISG) [1] was created to provide a uniform international sales law that would address the phenomenon of the globalisation of world trade and business practices of parties in different contracting states. The Convention is the result of legislative work initiated by the International Institute for the Unification of Private Law

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[1] United Nations Convention on Contracts for the International Sale of Goods, opened for signature 11 April 1980, 1489 U.N.T.S. 3 (entered into force 1 January 1988) (CISG).

(UNIDROIT) in the 1930s,[2] which has been taken over by the United Nations Commission on International Trade Law (UNCITRAL) following the Second World War.[3] These efforts culminated with the adoption of the CISG by a diplomatic conference in Vienna on 11 April 1980. The Convention entered into force on 1 January 1988 for its 11 original and diverse state parties, which included every geographical region, every stage of economic development and every major legal, social and economic system. As of May 2016, 85 states have ratified the CISG.[4]

The main purpose of the CISG is to bring about worldwide uniformity on the formation of international sales contracts and the legal rights and obligations of both the seller and the buyer.[5] Through "the development of international trade on the basis of equality and mutual benefit" the state parties to the CISG aim at "promoting friendly relations" among themselves.[6] This ultimate goal is to be achieved by

> "the adoption of uniform rules which govern contracts for the international sale of goods [that lie at the heart of all international trade transactions] and take into account the different social, economic and legal systems [which] would contribute to *the removal of legal barriers in international trade* and promote the development of international trade".[7]

A look at the Preamble to the Convention demonstrates that the drafters intended, "the adoption of *uniform* rules which govern contracts for the international sale of goods" and to

> "take into account the different social, economic and legal systems [which] would contribute to the removal of legal barriers in international trade and promote the development of international trade".[8]

Despite the Preamble's pledge the Convention explicitly excludes from its purview some highly important contractual issues, including the validity of the contract, which could significantly contribute to the fulfilment of the CISG's goals. Thus, instead of providing a declared unification of international sales law, the Convention undermines the unification purpose in relation to the contract validity as it exempts the concept from its scope of application, and yields it to the domestic sphere.[9] This exemption has been perceived to be a threat to the overall development and structural process of the CISG.[10]

A recent conference by the Swiss Association for International Law and UNCITRAL, held at the University of Basel on 29–30 January 2015, marked the

[2] International Institute for the Unification of Private Law, "History and overview" (29 July 2014) UNIDROIT 1, *http://www.unidroit.org/about-unidroit/overview* [Accessed 19 December 2016].

[3] UNCITRAL, United Nations Convention on Contracts for the International Sale of Goods (Vienna, 1980) (CISG), *http://www.uncitral.org/uncitral/en/uncitral_texts/sale_goods/1980CISG.html* [Accessed 12 December 2016].

[4] For the authoritative information on the status of the CISG, see the UNCITRAL and the UN Treaty Collection websites, *http://www.uncitral.org/uncitral/en/uncitral_texts/sale_goods/1980CISG_status.html*>; *http://treaties.un.org/* [Both accessed 12 December 2016].

[5] *http://www.uncitral.org/uncitral/en/uncitral_texts/sale_goods/1980CISG.html* [Accessed 12 December 2016].

[6] CISG, Preamble, Recital 2.

[7] CISG, Preamble, Recital 3 (emphasis added).

[8] CISG, Preamble, Recital 3.

[9] CISG art.4(a).

[10] H. E. Hartnell, "Rousing the Sleeping Dog: The Validity Exception to the Convention on Contracts for the International Sale of Goods" (1993) 18 *Yale Journal of International Law* 2, 2–4.

CISG's 35th anniversary.[11] The conference focused on the CISG's application, validity issues and the possibility of further harmonisation and unification of contract law.[12] The conference programme and discussion during the proceedings indicate that the substantive issue of contract validity is still an important topic and unresolved question.

The need to transform the CISG is the rationale behind this article. The article explores the question of how the contract validity could be best approached in international sales contracts governed by the Convention. The aim of this article is to highlight the factors underlying the validity exclusion, to draw attention to the consequences, and to recommend the prospective unification of the international sales law concerning contract validity. While all issues of contract validity deserve attention, owing to space constraints this article only considers mistake, fraud and unconscionability.

The article comprises four parts. The first part provides an introduction to the subject under examination. The second part concerns the effects of the absence of contract validity from the scope of the CISG. The third part surveys various methods on how to remedy the validity gap in the CISG and in particular addresses approaches to the process of unification taken at the European[13] and Asian[14] regional level, as well as endeavours made at the international level.[15] The fourth part suggests that in order to achieve harmonisation, the scope of inclusion of contract validity within the CISG should be considered in line with the efforts made at both regional and international level, and ultimately be balanced with the domestic laws.

The effects of the validity exception

Despite the CISG's large number of articles (101 articles), suggesting a comprehensive coverage of the issues relating to contracts for the international sale of goods, the scope of application of the Convention is in fact very limited. While a number of provisions specify the matters that do not fall within the scope of the CISG,[16] art.4 expressly determines the parameters of the Convention's application. Article 4 provides that:

> "This convention governs only the formation of the contract of sale and the rights and obligations of the seller and the buyer arising from such a contract. In particular, except as otherwise expressly provided in this convention, *it is not concerned with*:

[11] Swiss Association for International Law and UNCITRAL, "35 Years CISG and Beyond", University of Basel, Switzerland, 29–30 January 2015.

[12] Swiss Association for International Law and UNCITRAL, "35 Years CISG and Beyond", University of Basel, Switzerland, 29–30 January 2015.

[13] Commission on European Contract Law, "The Principles of European Contract Law (PECL), Trans-Lex", *http://www.trans-lex.org/400200*; EU, "The Principles of European Contract Law 2002 (Parts I, II, and II)", *http://www.jus.uio.no/lm/eu.contract.principles.parts.1.to.3.2002/* [Both accessed 12 December 2016].

[14] Principles of Asian Contract Law (PACL) (January 2011), *Fondation-droitcontinental*, *http://www.fondation-droitcontinental.org/en/document/the-pacl-principles-of-asian-civilcommercial-law-or-contract-law-in-east-and-southeast-asia/* [Accessed 12 December 2016].

[15] Proposal by Switzerland on possible future work by UNCITRAL in the area of international contract law, Note by the Secretariat—Possible future work in the area of international contract law, GA, UN GAOR, 45th sess., UN Doc. A/CN.9/758 (25 June – 6 July 2012) (*Swiss Proposal)*, pp.1, 2–4; *UNIDROIT Principles of International Commercial Contracts 2010 (PICC)* (1 August 2014), *http://www.unidroit.org/publications/513-unidroit-principles-of-international-commercial-contracts* [Accessed 12 December 2016].

[16] See, e.g., CISG arts 2, 3, 4 and 5.

(a) *the validity of the contract or of any of its provisions or of any usage*;
(b) the effect which the contract may have on the property in the goods sold."[17]

Pursuant to art.4, the Convention is only concerned with the formation of the contract of sale and with the rights and obligations of the seller and the buyer which arise from the contract. Unless expressly provided in the CISG, the Convention explicitly excludes from its purview "the validity of the contract or of any of its provisions or of any usage",[18] and "the effect which the contract may have on the property in the goods sold".[19] As far as issues of contract validity are concerned, they are relegated to the domestic realm, that is, the applicable domestic law. The proceeding part of this article considers the underlying reasons for the validity exception in view of the CISG's drafting history. Problems such as divergent interpretation and unpredictability are highlighted in order to show the effects of the validity exclusion, along with a brief discussion on specific factors, such as mistake, fraud and unconscionability being issues of contract validity currently consigned to the domestic fora.

The drafting history of CISG art.4

An examination of art.4(a) of the CISG in light of the drafting history can provide an understanding of the validity exclusion and the intentions behind it.[20] Efforts to harmonise the law on the international sale of goods stretch back to 1929 when Ernst Rabel initiated the drafting of an international uniform sales law.[21] Starting its work under the auspices of the League of Nations, the UNIDROIT eventually produced two conventions: the Uniform Law for the International Sale of Goods (ULIS)[22] and the Uniform Law on the Formation of Contracts for the International Sale of Goods (ULF),[23] both adopted at The Hague Conference on Uniform Law for International Sales in 1964.[24] For a plethora of reasons, UNIDROIT's efforts failed to receive substantial support.[25] This, however, did not prevent further work on unification of contract law, with UNCITRAL taking over the task to draft a uniform international law on contracts for the sale of goods. A working group comprising representatives from 15 Member States was appointed to this end and was instructed by the UNCITRAL to determine whether it was necessary to retain the existing text or to produce a new text for the same purpose.[26]

In terms of the validity exception, the Commission decided to request the Working Group "to consider the establishment of uniform rules governing the

[17] CISG art.4 (emphasis added).
[18] CISG art.4(a).
[19] CISG art.4(b).
[20] J.P. Quinn, "The Interpretation and Application of the United Nations Convention on Contracts for the International Sale of Goods" (2004) 9 *International Trade and Business Law Review* 221, 221–224.
[21] P. Schlechtriem, "Uniform Sales Law—The UN Convention on Contracts for the International Sale of Goods", Pace Law School (1986), p.16, *http://www.cisg.law.pace.edu/cisg/biblio/schlechtriem.html* [Accessed 12 December 2016].
[22] Convention Relating to a Uniform Law on the International Sale of Goods, 1 July 1964, 834 U.N.T.S. 107 (1972) (ULIS).
[23] Convention Relating to a Uniform Law on the Formation of Contracts for the International Sale of Goods, 1 July 1964, 834 U.N.T.S. 169 (1972) (UL).
[24] See, generally, *http://www.cisg.law.pace.edu/cisg/text/antecedents.html* [Accessed 5 January 2017].
[25] ULIS and ULF were ratified by nine states.
[26] J. Hannold, "The Draft Convention of Contract for the International Sale of Goods: An Overview" (1979) 27 *American Journal of Comparative Law* 223.

validity of contracts … on the basis of the UNIDROIT draft".[27] However, examination of the report by the Secretary-General reveals a recommendation that contract validity should not be extended to matters which "rarely arise in contracts for international sale of goods" and when "such events [do] occur, they can usually be handled [by] non-uniform national law".[28]

While CISG's predecessors, ULIS and ULF, did not attract worldwide ratification, they did serve as a basis for CISG provisions.[29] Article 4(a) of the CISG, which expressly excludes the issue of validity from international sale contracts governed by this convention, is based on, developed from and remains similar to art.8 of the final version of the ULIS (1964) (tracing back to art.11 of the 1939 draft ULIS[30] which contained the first form of exclusion). Examination of observations reprinted in the 1964 *Hague Conference Documents* reveals objections to the exclusion of validity from the ULIS. For example, in relation to art.12 of the 1956 draft ULIS (later ULIS art.8) the Hungarian delegation noted the following:

> "Leaving on one side the point that this Article deals with a question which — according to the sense of Article 12 — should have been left outside the draft, we do not find ourselves in agreement with the content of this Article."[31]

Similarly, the Federal Republic of Germany delegation expressed the opinion that the Uniform Law failed to live up to its name insofar as "its authors do not propose to achieve complete unification of the law" and left "questions of great importance, such as the validity of the contract to domestic law".[32] However, the German delegation accepted the exclusion owing to the "difficulty of unification of law" and since it considered that "if this unification is to be achieved, it will be only by stages".[33]

The drafting history of art.4(a) reveals the intent behind the consideration to "neither [disturb] the deeply ingrained notions of public policy … nor [to try] to legislate what public policy should be for all nations".[34] The debate on the validity exception was not resolved but rather avoided to allow for elasticity of differing national law jurisdictions.[35]

[27] *Report of the Secretary-General*, 8th sess., UN Doc A/CN.9/128/Annex II (4–14 January 1977).

[28] *Report of the Secretary-General*, 8th sess., UN Doc A/CN.9/128/Annex II (4–14 January 1977) paras 92–93.

[29] Hartnell, "Rousing the Sleeping Dog" (1993) 18 *Yale Journal of International Law* 2, 5.

[30] Draft of a Uniform Law on the International Sale of Corporeal Movables and Report (Revised Edition), UNIDROIT UPL 1939, Draft 1(2) (1939 Draft ULIS), which the UNIDROIT Governing Council approved on 29 May 1939. For an overview of the 1939 Draft ULIS see also E. E. Bergsten and A.J. Miler, "The Remedy of Reduction of Price" (1979) 27 *American Journal of Comparative Law* 255.

[31] Observations of the Hungarian Government on the 1956 Draft ULIS, reprinted in *Diplomatic Conference on the Unification of Law Governing the International Sale of Goods (Documents)*, The Hague, 2–25 April 1964 (1966) (Hague Conference Documents), p.122.

[32] Observations of Government of Federal German Republic on 1956 Draft ULIS, reprinted in *Hague Conference Documents* (1966), p.82.

[33] Observations of Government of Federal German Republic on 1956 Draft ULIS, reprinted in *Hague Conference Documents* (1966), p.82.

[34] B.B. Crawford, "Drafting Considerations under the 1980 United Nations Convention on Contracts for the International Sale of Goods" (1988) 8 *Journal of Law and Commerce* 187, 191.

[35] B. Zeller, *CISG and the Unification of International Trade Law* (Abingdon: Routledge, 2008).

Consequences of the validity exclusion

The validity exclusion foreshadows a range of problems with matters such as divergent interpretations and unpredictability.[36]

Divergent interpretations

In accordance with art.7, in interpreting the CISG, "regard is to be had to its *international character* and to the need to *promote uniformity* in its application and *the observance of good faith* in international trade".[37] The guidelines in art.7 emphasise that the CISG is a legal instrument that is "international" in character and thus needs to be interpreted independently from idiosyncratic national approaches. This suggests that autonomous interpretation must be made in consideration of the overall objective and purpose of the Convention rather than in accordance with domestic law.[38]

However, with no primary point of reference as to the interpretation of validity, different courts may give different "autonomous" interpretations, deviating from the Convention's purpose of promoting a set of uniform rules.[39] With international trade occurring on a day-to-day basis globally, the interpretation of validity in different countries entrenched with different cultures and legal backgrounds can lead to differing, even conflicting, results.[40]

The possibility of divergent interpretations is contrary to the purpose of the CISG to provide a "uniform" law. The requirement of art.7(1) that "regard is to be had to its *international* character" demands that judges move from rules and techniques promulgated for the interpretation of domestic legislation and adopt a

[36] In addition to excluding validity issues, the CISG, in accordance with art.6, also allows the contracting parties to exclude the operation of the Convention in its entirety, or exclude or amend any of its provisions, which also increases the use of declarations and/or reservations permitted under art.95. The uncertainties arising from the opting out clause and/or reservations, coupled with the already limited scope of the CISG on validity issues, as well as the lack of familiarity with the Convention, may result in a situation where parties are more comfortable to turn to their own (familiar) domestic law, thereby further hindering uniformity, predictability and the success of the *Convention*. See, e.g., J. Hannold, *Uniform Law for International Sales under the 1980 United Nations Convention*, 3rd edn (Kluwer Law International, 1999), p.39; P. L. Fitzgerald, "The International Contracting Practices Survey Project: An Empirical Study of the Value and Utility of the United Nations Convention on the International Sale of Goods (CISG) and the UNIDROIT Principles of International Commercial Contracts to Practitioners, Jurists, and Legal Academics in the United States" (2008) 27 *Journal of Law and Commerce* 1, 7–10.

[37] CISG art.7(1) (emphasis added).

[38] B. Zeller, "Penalty Clauses: Are They Governed by the CISG" (2011) 23 *Pace International Law Review* 1. For a discussion on uniformity see also J. Felemegas, "The United Nations Convention on Contracts for the International Sale of Goods: Article 7 and Uniform Interpretation" in *Pace International Law Review (ed.), Pace Review of the Convention on Contracts for the International Sale of Goods (CISG)* (Kluwer Law International, 2000–2001), pp.115–265; L. Spagnolo, "Opening Pandora's Box: Good Faith and Precontractual Liability in the CISG" (2008) 21 *Temple International and Comparative Law Journal* 161; P. Soni, "The Benefits of Uniformity in International Commercial Law with Special Reference to the United Nations Convention on Contracts for the International Sale of Goods (1980)" (Dissertation, 2012), *http://www.cisg.law.pace.edu/cisg/biblio/soni.html* [Accessed 5 January 2017].

[39] I. Schwenzer, C. Fountoulakis and M. Dimsey, *International Sales Law: A Guide to the CISG* (London: Bloomsbury Publishing, 2012).

[40] Insufficient familiarity with the CISG is another cause for divergent results. See, e.g., *Société Dig v Société Sup*, 05-13.538, 13 February 2007, reported in (2007) (concerning defective computer components, where Société Sup, the seller, was ordered to pay the buyer damages; the Paris Court of Appeal reversed the judgment on the basis that limitation clauses on guarantee and exemption of responsibility were matters valid under the CISG. The judgment was annulled as a breach of CISG art.4 and the parties returned to their respective positions before the judgment.). See also J.A. Spanogle and P. Winship, *International Sales Law: A Problem-Oriented Coursebook* (West Academic, 2000).

more flexible approach that considers the underlying purpose and policies of individual provisions as well as the Convention as a whole.[41]

The requirement of good faith referred to in art.7(1) is another issue. While the principle of good faith is upheld in many legal systems, its treatment may vary. For example, while some common law states apply the principle of good faith to contract performance only, civil law states apply good faith to contract formation and interpretation as well. This creates a situation where negotiations prior to the acceptance of a contract are subject to the requirement of good faith and a breach may raise a claim in *culpa in contrahendo*.[42]

In order to avoid divergent interpretations, national standards should be adopted only as far as they are comparative.[43] This may prove difficult since most domestic laws on sales and obligations are nearly 100 years old. Ernst Rabel was of the opinion that one of gains to be derived from uniform law is that it would avoid "awesome relics of the dead past that populate in amazing multitude the older codifications of sales law".[44] To achieve this, the CISG must generally be interpreted and applied uniformly.[45] With respect to the validity exception in particular, Professor Hartnell advises that the exclusion suggests the emergence of a functional view of validity, where validity issues refer to issues that render the adoption of a uniform law, or its uniform interpretation, difficult.[46]

The lack of definitive outlines to the validity exception gives rise to the risk of domestic governing laws determining the validity of a contract and, in turn, adding to the costs of international contracting.[47] This could be avoided by harmonising the international sales law by including provisions regarding contract validity in the CISG, whereby the states parties to the Convention would be able to avoid costs associated with familiarising themselves with the applicable foreign law, thereby reducing transactional costs.[48] Similarly, addressing the validity requirements for contracts would preclude courts from using their domestic laws as a point of reference,[49] promote unification of the laws for the international sale of goods and decrease the current legal unpredictability.

[41] N. Povrzenic, "Interpretation and Gap-Filling under the United Nations Convention on Contracts for the International Sale of Goods", Pace Law School (1998), *http://www.cisg.law.pace.edu/cisg/biblio/gap-fill.html* [Accessed 13 December 2016].

[42] Povrzenic, "Interpretation and Gap-Filling under the United Nations Convention on Contracts for the International Sale of Goods" (1998), *http://www.cisg.law.pace.edu/cisg/biblio/gap-fill.html* [Accessed 13 December 2016].

[43] Povrzenic, "Interpretation and Gap-Filling under the United Nations Convention on Contracts for the International Sale of Goods" (1998), *http://www.cisg.law.pace.edu/cisg/biblio/gap-fill.html* [Accessed 13 December 2016].

[44] Hannold, *Uniform Law for International Sales under the 1980 United Nations Convention* (1999), p.21.

[45] Hannold, *Uniform Law for International Sales under the 1980 United Nations Convention* (1999), p.21.

[46] Hartnell, "Rousing the Sleeping Dog" (1993) 18 *Yale Journal of International Law* 2, 31.

[47] G. Cuniberti, "Is the CISG benefiting anybody?" (2006) 39 *Vanderbilt University Journal of Transnational Law* 1511; I. Schwenzer, "Regional and Global Unification of Contract Law' (2011) 13 *European Journal of Law Reform* 39, 54; M. B. Lopez, "Resurrecting the Public Good: Amending the Validity Exception in the United Nations Convention on Contracts for the International Sale of Goods for the 21st Century" (2010) 10 *Journal of Business and Securities Law* 133, 164.

[48] Lopez, "Resurrecting the Public Good" (2010) 10 *Journal of Business and Securities Law* 133, 164.

[49] C. Sheaffer, "Failure of the United Nations Convention on Contracts for the International Sale of Goods and a Proposal for a New Uniform Global Code in International Sales Law" (2007) 15 *Cardozo Journal of International and Comparative Law* 461.

Unpredictability

The validity exclusion has resulted in inconsistency in the application of the CISG and in legal uncertainty.[50] The task of determining invalidity has been left to the domestic regulatory framework, omitting continuity in expectations by foreign parties. Without an applicable law in the CISG regarding contract validity, the difficult task is then to decide which law governs the contract and, furthermore, whether the law is precise enough.[51] Legal uncertainty ultimately undermines the Convention's purpose to provide a uniform set of laws governing international sales contracts, and detracts the willing participation and adoption by prospective states as a means to rely upon in their international transactions.[52]

An important factor impairing the predictability of the Convention is related to defining the very term "validity", the importance of the matter becoming apparent when considering the discrepancies observed between national courts' interpretation of the definition.[53] The drafters of the Convention did not define the term "validity".[54] Although the drafters did exchange views on whether certain issues fell within the ambit of the exclusion, and suggested issues to be excluded, the apparent lack of debate demonstrates that the drafters intended to keep the term ambiguous.[55] During the debates on the contradictions in the text of the uniform law (art.8 of the ULIS), the drafters rarely indicated why some issues are validity issues, but others are not, or explored the differences between issues of validity and issues of formation in great depth. The drafters, however, did indicate that the guiding principle behind the exclusion clause was closely tied to matter of "public policy and morality", and the need to protect certain categories of persons.[56] The drafting history of the CISG suggests that the drafters intended art.4(a) to serve as a loophole that would accommodate the various domestic legal systems in order to avoid residual issues under debate, circumventing a lack of agreement and substantial delays.[57] As a result, the validity debate was not resolved but rather deferred.[58]

In addition, although the exclusion of validity issues ultimately promoted the adoption of the CISG, the exclusion of validity issues is particularly disappointing in the context of the Convention's importance for the enhancement of developing economic systems. Regions such as Africa could look to the CISG as a neutral body of law to help facilitate growth for businesses that are unable to afford the high costs of research and litigation of foreign laws.[59]

In this respect, it needs to be kept in mind that the CISG is an international legal instrument committed to the overall purposes of the United Nations. The purpose

[50] I. Schwenzer and P. Hachem, "The CISG—Successes and Pitfalls" (2009) 57 *American Journal of Comparative Law* 457, 471–472.

[51] D.V. Vorobey, "CISG and Arbitration Clauses: Issues of Intent and Validity" (2013) 31 *Journal of Law and Commerce* 135, 159–161.

[52] Hartnell, "Rousing the Sleeping Dog" (1993) 18 *Yale Journal of International Law* 2.

[53] F. Ferrari, "PIL and CISG: Friends or Foes" (2012) 31 *Journal of Law and Commerce* 45.

[54] Hartnell, "Rousing the Sleeping Dog" (1993) 18 *Yale Journal of International Law* 2, 20.

[55] Hartnell, "Rousing the Sleeping Dog" (1993) 18 *Yale Journal of International Law* 2, 20

[56] See, e.g., Observations of the Governments of Finland, Sweden and Norway Submitted before the Opening of the Diplomatic Conference, UN Docs. V/Prep./9, 10 and 13, reprinted in *Hague Conference Documents* (1966), pp.268–269.

[57] Hartnell, "Rousing the Sleeping Dog" (1993) 18 *Yale Journal of International Law* 2, 21.

[58] Hartnell, "Rousing the Sleeping Dog" (1993) 18 *Yale Journal of International Law* 2, 21.

[59] Lopez, "Resurrecting the Public Good" (2010) 10 *Journal of Business and Securities Law* 133, 152.

of the CISG therefore should not be isolated from other international legal instruments. One of the purposes of the UN is

> "[t]o achieve international cooperation in solving international problems of an economic, social, cultural, or humanitarian character, and in promoting and encouraging respect for human rights and for fundamental freedoms for all without distinction as to race, sex, language, or religion".[60]

The exclusion of validity issues from the CISG counteracts this core purpose of the UN since, as a result, the CISG fails to address issues relating to public policy and fairness.[61]

Some validity factors considered

Despite the varying definitions of the term "validity" at the domestic level, and the associated difficulties regarding its definition at the international level,[62] there is international consensus that certain issues, such as mistake, fraud and unconscionability, do fall under the umbrella of "validity".[63] This section juxtaposes the consequences of the validity exclusion from the CISG against these three validity factors.

Mistake

Mistake refers to an erroneous belief upon which the contract was made.[64] The doctrine of mistake has been an important development for contract law, granting parties the ability to prevent or relieve themselves from a contract where basic assumptions held at the time of contracting vital to the agreement were incorrect.[65] Considering the vast number of scenarios involved in mistake, it has already been hard enough for domestic laws to ensure uniformity of decisions that comply with the CISG.[66] For example, in *Smith v Hughes*,[67] under the English law jurisdiction, after receiving samples of oats the defendant entered a contract for what he thought were "old oats". The court held that no mistake per se existed since the condition was neither a stated term of the contract nor a mere contractual assumption. In contrast, in *Scriven Bros v Hindley*,[68] also under English law, where the defendant made a bid at an auction for two lots believing they were both hemp, and where in fact, the second lot was tow, owing to which the defendant declined to pay, the court found that since the mistake was due to the labelling of goods by the plaintiff,

[60] Charter of the United Nations, signed on 26 June 1945 59 Stat, 1031; TS 993; 3 Bevans 1153 (entered into force 24 October 1945) art.1(3).
[61] Lopez, "Resurrecting the Public Good" (2010) 10 *Journal of Business and Securities Law* 133, 153–154.
[62] M. Bridge, "Law for International Sale of Goods" (2007) 37 *Hong Kong Law Journal* 17, 24.
[63] Lopez, "Resurrecting the Public Good" (2010) 10 *Journal of Business and Securities Law* 133, 144; J. Lookofsky, *Understanding the CISG*, 4th edn (Kluwer Law International, 2012); H.M. Flechtner, "More US Decisions on the UN Sales Convention: Scope, Parol Evidence, Validity and Reduction of Price under Article 50" (1994) 14 *Journal of Law and Commerce* 153, 164–168.
[64] I. Ayres and A. Schwartz, "The No-Reading Problem in Consumer Contract Law" (2014) 66 *Stanford Law Review* 545, 558.
[65] C. MacMillan, *Mistakes in Contract Law* (London: Bloomsbury Publishing, 2010), pp.205, 206.
[66] F. Ferrari, "Have the Dragons of Uniform Sales Law been Tamed? Ruminations on the CISG's Autonomous Interpretation by Courts" in C. Baasch Andersen and U. G. Schrowter (eds), *Sharing International Commercial Law across National Boundaries: Festschrift for Albert H. Kritzer on the Occasion of his Eightieth Birthday* (Wildy, Simmonds and Hill, 2008), p.134 at pp.139–141.
[67] *Smith v Hughes* (1871) L.R. 6 Q.B. 597.
[68] *Scriven Bros & Co v Hindley & Co* [1913] 3 K.B. 564.

the contract was void.[69] These two cases are the examples that involve similar factual situations with different outcomes vis-à-vis validity, demonstrating that divergent results could arise even in the same legal system.

Fraud

The concept of fraud in the context of a sale contract refers to the illegal act of misrepresentation, where one party to the contract intentionally presents material facts that are deceitful, misleading or incorrect.[70] In the case of *Nobel Co Ltd v ADI Co Ltd, Long Yuan Co Ltd and Huadian Co Ltd*,[71] under Chinese law, the plaintiff signed an agreement with the defendants that entitled the plaintiff to an exclusive right to Marketing Printer Okipage-4w, a product of OKI Printing Solutions, in the Chinese market. The authorisation agreement was not recognised by OKI since Nobel "failed to achieve the sales data stipulated under the agreement".[72] The court held that since the defendants concealed the truth and deceived the plaintiff, the agreement was invalid. In *Krysa v Payne*,[73] decided in Missouri, US, where the plaintiff was induced by information supplied by the defendant to purchase a car, although the vehicle had multiple owners instead of the one as claimed, and further inspection also revealed several additional problems, the court held that the contract was void on the basis that Payne was aware of the damages to the truck, and continued to take steps to mislead Krysa. There was a clear intention of fraud in both cases, rendering the contracts void in two different jurisdictions. By contrast to the above-mentioned cases, in *Discount Records v Barclays Bank*,[74] decided in the UK, where the plaintiff sought a pre-trial injunction to restrain the bank from paying since the plaintiff was made aware that only half the shipment sent was filled with goods and the other half was filled with rubbish, the court rejected the plaintiff's argument on the grounds that fraud had been alleged, however, not yet proven.[75] This case demonstrates a more complex perspective on fraud. The difference in requirements highlights the importance of contract validity, which occurs in day-to-day contracts of sale, and ultimately underlines the necessity of a uniform contract law.[76]

Unconscionability

Unconscionability, or gross disparity in the context of international trade, refers to the disadvantage caused to a party that is in a weak bargaining position.[77] The 1989 UNIDROIT *Validity Study* emphasises that unconscionability can be shown

[69] R. Sefton-Green, *Mistake, Fraud and Duties to Inform in European Contract Law* (Cambridge University Press, 2005) 67–72.
[70] J. Rivera, "Legal Match, What is Contract Fraud?", *http://www.legalmatch.com/law-library/article/what-is-contract-fraud.html* [Accessed 13 December 2016].
[71] *Nobel Co Ltd v ADI Co Ltd, Long Yuan Co Ltd and Huadian Co Ltd* (2000).
[72] *Nobel Co Ltd v ADI Co Ltd, Long Yuan Co Ltd and Huadian Co Ltd* (2000) at [11].
[73] *Krysa v Payne* 176 SW 3d 150 (Mo. Ct App. 2005).
[74] *Discount Records v Barclays Bank* [1975] 1 All E.R. 1071 Ch D.
[75] *Discount Records v Barclays Bank* [1975] 1 All E.R. 1071.
[76] I. Schwenzer, "Who Needs a Uniform Contract Law, and Why?" (2013) 58 *Villanova Law Review* 723, 729.
[77] Hartnell, "Rousing the Sleeping Dog" (1993) 18 *Yale Journal of International Law* 2, 81.

where there is "gross disparity between the obligations of the parties" or "contract clauses grossly upsetting the contractual equilibrium".[78]

The exclusion of validity issues from the scope of the Convention results in a situation where issues relating to unconscionability are heard before and determined by domestic laws with different rules, which could lead to inconsistencies and divergent results. This is particularly troubling owing to the large use of standard forms and waivers in commercial transactions. Ziegel and Samson report that the exclusion of validity issues from the scope of the Convention would be

> "of particular importance where the contract contains a disclaimer clause restricting or excluding liability for breach of warranty or other obligation imposed on the seller under the *Convention* and the buyer invokes the doctrine of "fundamental breach" or impeaches the clause on grounds of unconscionability".[79]

As with other validity issues, different legal systems approach the concept of unconscionability differently. For example, in the US, while under the Uniform Commercial Code (UCC) the courts would examine both procedural unconscionability and substantive unconscionability, under Japanese law there are no statutory provisions dealing with unconscionability. Instead, issues of unconscionability are merely addressed against public policy, the doctrine of good faith, abuse of rights or tort.[80] The exclusion of validity issues from the CISG also leads to challenges for authors of waivers themselves. A main challenge is matching the disclaimer to the variety of possible applicable laws with different requirements.[81]

Summary

After much consideration of the effects of the validity exclusion, the reason why it is still excluded remains unclear. Although 2015 marked the CISG's 35th anniversary, the fact that contract validity proved to be one of the main subjects for discussion at the Basel Conference implies that the apparent success of the Convention is fragile.[82] Despite the overall success of the CISG, hesitation still exists, which is illustrated by reported findings that in the US, for example, between 55 and 57 per cent of lawyers typically opt out from the CISG owing to both unfamiliarity and lack of certainty.[83] The situation is also alarming in other states.[84]

[78] UNIDROIT 1989 *Validity Study*, L: Doc 43 (1989), pp.11–13. See generally, Study L - Principles of International Commercial Contracts - Preparatory Work, *http://www.unidroit.org/preparatory-work-principles-1994* [Accessed 5 January 2017].

[79] J.S. Ziegel and C. Samson, *Report to the Uniform Law Conference on Canada on [the] Convention on Contracts for the International Sale of Goods* (July 1981), p.42.

[80] A. Newhouse and T. Tsuneyoshi, "CSOG—A Tool for Globalization (1): American and Japanese Perspectives" (2012) 29 *Ritsumeikan Law Review* 28.

[81] Newhouse and Tsuneyoshi, "CSOG—A Tool for Globalization (1): American and Japanese Perspectives" (2012) 29 *Ritsumeikan Law Review* 28, 31.

[82] Swiss Association for International Law and UNCITRAL, "35 Years CISG and Beyond", University of Basel (January 2015).

[83] Fitzgerald, "The International Contracting Practices Survey Project" (2008) 27 *Journal of Law and Commerce* 1, 64.

[84] See, e.g., L. Spagnolo, "Law Wars: Australian Contract Law Reform v CISG v CESL" (2013) 58 *Villanova Law Review* 623; F. Aghili, "A Critical Analysis of the CISG as Australian Law" (December 2007 — February 2008) 21 *Commercial Law Quarterly*. For discussion about the "neglect" of the CISG, see generally J.E. Murray Jr, "The Neglect of CISG: A Workable Solution" (1998) 17 *Journal of Law and Commerce* 365; M. Kilian, "CISG and the Problem with Common Law Jurisdictions" (2001) 10 *Transnational Law and Policy* 217.

Perhaps because the worldwide success story of the CISG depends very little on the issue of contract validity, the Convention's overall ability to function is not at stake or questioned entirely.[85] Nevertheless, it has been suggested that the use of the CISG may decrease and eventually fade in favour of more cost-effective, business-friendly models of international trade law.[86] Given the growing number of state parties and their desire for a uniform regime of trade law, however, this appears unlikely. Then again, the impediments presented by the CISG as an incomplete body of law omitting important issues such as validity, coupled with the absence of an international adjudicatory body capable of producing binding internationalised decisions, support the contention that the CISG may, in time, become less relevant unless changes are made.[87]

Reconsidering the validity exception

Establishing the CISG as the governing law on contract validity is significant to the practice of international business transactions and the promotion of legal uniformity.[88] The preceding part of this article addressed the consequences of the validity exclusion. This part discusses the suggested route to the integration of the concept within the ambit of the CISG, with the aim to strike a balance in contractual validity laws. The Preamble to the CISG clearly states that "the development of international trade on the basis of equality and mutual benefit is an important element in promoting friendly relations among States".[89] Having that issues concerning public policy, unconscionability, fraud and mistake, also concern societal benefits and equality, the CISG's failure to address these issues by excluding the validity of the contract, and its subsequent reliance on varied domestic legal forums, results in a frustration of the Convention.[90]

An array of strategies could be utilised to minimise this frustration. One option could be to adopt a protocol to the CISG that defines validity and provides a non-exhaustive list of validity issues, which would provide guidance while still maintaining jurisdictional autonomy. In addition, various initiatives to harmonise contract law, including regional initiatives in Asia and Europe, could be considered.[91] Equally worthy of consideration are international attempts to fill in the gaps in the CISG.

[85] Schwenzer and Hachem, "The CISG—Successes and Pitfalls" (2009) 57 *American Journal of Comparative Law* 457.

[86] See, e.g., A. Janssen and O. Mayer, *CISG Methodology* (Munich: Sellier, European Law Publishers, 2009), p.58.

[87] Lopez, "Resurrecting the Public Good" (2010) 10 *Journal of Business and Securities Law* 133, 166.

[88] M. del Pilar Perales Viscasillas, "Battle of the Forms under the 1980 United Nations Convention on Contracts for the International Sale of Goods: A Comparison with Section 2-207 UCC and the UNIDROIT Principles" (1998) 10 *Pace International Law Review* 97.

[89] CISG, Preamble, Recital 3.

[90] Lopez, "Resurrecting the Public Good" (2010) 10 *Journal of Business and Securities Law* 133, 166, 167–168.

[91] According to the World Trade Organization *Merchant Report* issued in October 2014 for 2013, Europe-Asia combined merchandise trade amounted to 66% of world trade. See World Trade Organization, *World Region Report on Merchandise Trade* (October 2014), p.1. In addition to PACL and PECL there have been other regional initiatives to harmonise contract law, including Africa. See Acte Uniforme portant sur le Droit commercial general (Uniform Act on General Commercial Law) (15 December 2010), Organization Pour L'Harmonisation en Afrique du Droit des Affaires (Organisation for the Harmonisation of Business Law in Africa) (OHADA), *http://www.ohada.org/presentation-generale-de-lacte-uniforme/telechargements.html*.

Regional model law initiatives

The Principles of Asian Contract Law

The Principles of Asian Contract Law (PACL) is a private initiative aiming to promote worldwide contract compatibility, including contract validity.[92] The need for harmonisation within the East Asia region reflects the changing world since the birth of the CISG. The PACL, designed by Asian scholars, is the regional model law without any binding force of law.[93] It is still being developed.[94]

The PACL consists of two books. Book 1 covers general provisions. Book 2 comprises six substantive chapters, each being prepared by different drafters. Chapter 4 of Book 2, drafted by Japan, is focused on the validity of contracts and is relatively simple compared with other provisions.[95] Section 1of Ch.4 specifies the grounds for invalidity and s.2 of Ch.4 addresses the effects of invalidity. Section 1 specifically states the scope of the section, mandatory provisions and addresses specific issues such as mistake, fraud and unfair exploitation. Unlike the CISG, which leaves validity issues to the realm of diverse domestic legal jurisdictions, the PACL provides guidance on specific validity issues and is thus likely to promote uniformity and reduce uncertainty if states in the region reach a consensus. Section 2 provides clear guidance on the effects of invalidity.

Varied cultural and ideological milieus in Asia imply that the implementation of the PACL may be difficult. Nevertheless, Professor Ka argues that while it is unlikely that cultural and ideological differences would dominate the area of contract law, if such cultural differences should be reflected in the PACL they would not hinder but rather enrich the PACL.[96] Another advantage of the PACL is that it aims to address both common law and civil law principles.[97] This is particularly relevant in view of the different legal rules and, hence, interpretations of the CISG, in common law and civil law jurisdictions. Still, unlike the existing European regional project (discussed below), on which it is modelled, and which enjoyed the support of the EU, the "PACL does not have the privilege of support from the regional political community"[98]—a factor that might also impact on its implementation.

The principles of European contract law

The Principles of European Contract Law (PECL) is the European regional model contract law containing rules drawn up by leading European scholars in the field.[99] These principles reflect the requirements of the European domestic trade. They are designed to "provide maximum flexibility and thus accommodate future

[92] PACL (January 2011), *Fondation-droitcontinental*, *http://www.fondation-droitcontinental.org/en/document/the-pacl-principles-of-asian-civilcommercial-law-or-contract-law-in-east-and-southeast-asia/* [Accessed 12 December 2016]. See also S. Han, "Principles of Asian Contract Law: An Endeavor of Regional Harmonization of Contract Law in East Asia" (2013) 58 *Villanova Law Review* 589, 592.
[93] Han, "Principles of Asian Contract Law" (2013) 58 *Villanova Law Review* 589, 592.
[94] J. Ka, "Introduction to PACL" (2013) 17 *Comparative Law Journal of the Pacific* 55, 55.
[95] Ka, "Introduction to PACL" (2013) 17 *Comparative Law Journal of the Pacific* 55, 55.
[96] Ka, "Introduction to PACL" (2013) 17 *Comparative Law Journal of the Pacific* 55, 63.
[97] Ka, "Introduction to PACL" (2013) 17 *Comparative Law Journal of the Pacific* 55, 65.
[98] Ka, "Introduction to PACL" (2013) 17 *Comparative Law Journal of the Pacific* 55, 55.
[99] PECL, *Trans-Lex*, *http://www.trans-lex.org/400200* [Accessed 12 December 2016].

development in legal thinking in the field of contract law".[100] The PECL comprises three parts: Pt 1, published in 1995; Pt 2, finalised in 1999; and Pt 3, completed in 2002.[101] Matters relating to validity are set out in Ch.4 of Pts 1 and 2 to include, inter alia, mistake, fraud and unconscionability (excessive benefit or unfair advantage).

Where there is fraud, for example,

> "a party may avoid a contract when it has been led to conclude it by the other party's fraudulent representation whether by words or conduct, or fraudulent non-disclosure of any information which in accordance with good faith and fair dealing it should have disclosed".[102]

In the case of mistake, a party may avoid a contract on the basis of the information given, where the other party knew or ought to have known of the mistake and left the mistaken party in error, and where both parties made the same mistake.[103] A party may also avoid a contract owing to unconscionability where, at the time of the conclusion of the contract, the innocent party suffered a disadvantage (economic distress, urgent needs, improvidence, ignorance, inexperience or lack of bargaining skills) and the other party knew of the disadvantage and took advantage of the disadvantage to their own benefit.[104]

It is important to note, however, that although inspired by the CISG, the PECL, like PACL, and similar initiatives, such as the American Restatement of the Law of Contract, to which the PECL has been compared,[105] are a so-called soft law, meaning that its rules are not enforced on behalf of the state.

International efforts

Efforts to unify the laws for the sale of goods, including contract validity, have also been made at the international level.[106] The Swiss Proposal to the UNCITRAL General Assembly and the UNIDROIT Principles of International Commercial Contracts (PICC) are noteworthy examples.

The Swiss Proposal

The Swiss Proposal was made in preparation for the 25 June 2012 UNCITRAL meeting in New York. This proposal highlighted the potential for future work by UNICITRAL to reconsider questions that are currently excluded from the CISG and thus left to domestic laws and also to address the work which has been done

[100] L. Ole and B. Hugh, *Principles of European Contract Law, Parts I and II, prepared by the Commission on European Contract Law* (2000), p.xxvii.

[101] See, e.g., The Commission on European Contract Law, "Introduction to the Principles of European Contract Law", *http://www.cisg.law.pace.edu/cisg/text/peclcomments.html* [Accessed 12 December 2016].

[102] PECL art.4:107(1)2.

[103] PECL art.4:103.

[104] PECL art.4:109. Considering that the PACL is based on the PECL as a key inspiration model and guideline, it would be reasonable to infer that similar provisions regarding mistake, fraud and unconscionability will be integrated into the PACL. See Ka, "Introduction to PACL" (2013) 17 *Comparative Law Journal of the Pacific* 55, 57.

[105] The Commission on European Contract Law, "Introduction to the Principles of European Contract Law"*http://www.cisg.law.pace.edu/cisg/text/peclcomments.html* [Accessed 12 December 2016].

[106] The Commission on European Contract Law, "Introduction to the Principles of European Contract Law"*http://www.cisg.law.pace.edu/cisg/text/peclcomments.html* [Accessed 12 December 2016].

at the regional level in order to harmonise contract law.[107] In particular, Switzerland proposed that the UNICITRAL would assess the CISG and its practicalities alongside the question of whether further work is desirable and feasible in a global context.[108]

The Swiss Proposal acknowledged the success of the CISG, noting that the Convention governs some 80 per cent of international sales contracts. It also emphasised its influence on subsequent attempts to harmonise and reform contract laws at both regional and national level.[109]

Despite the CISG's strong influence on regional endeavours to harmonise and unify general contract law, the Swiss Proposal contends that regional efforts cannot adequately meet the needs of international trade. Instead, "UNCITRAL is the most appropriate forum for further work on international contract law for business-to-business transactions".[110] The Proposal suggests that UNCITRAL's work should cover a range of topics, including "validity, among others: mistake, fraud, duress, gross disparity, unfair terms, illegality".[111] Based on the Swiss Proposal, UNCITRAL should first identify the areas where UNCITRAL work would be complementary to existing instruments, and then discuss what particular form UNCITRAL's future work on general contract law might take.[112] These are undoubtedly complex tasks requiring time and effort to be invested before they yield practical results.

Notwithstanding the possible hurdles, it has been argued that, for a range of reasons, there is "the urgent need to further harmonise, if not unify, general contract law".[113] While praising the work that has been completed by the UNIDROIT, namely, the PICC, and cautioning that "any duplication of efforts must be prevented",[114] Professor Schwenzer reminds us that

> "there are certain contradictions between CISG and PICC that need to be eliminated [and that] in other areas the possible acceptance of PICC rules at a global level must be carefully scrutinized and discussed".[115]

[107] The Commission on European Contract Law, "Introduction to the Principles of European Contract Law"*http://www.cisg.law.pace.edu/cisg/text/peclcomments.html* [Accessed 12 December 2016]. See also Swiss Proposal (25 June – 6 July 2012); "Switzerland proposes future work by UNCITRAL on international contract law" (18 May 2012), *European Private Law News*, *http://www.epln.law.ed.ac.uk/2012/05/18/switzerland-proposes-future-work-by-uncitr…* [Accessed 13 December 2016].

[108] Swiss Proposal (25 June – 6 July 2012).

[109] "Switzerland proposes future work by UNCITRAL on international contract law", (18 May 2012), para.6, *European Private Law News*, *http://www.epln.law.ed.ac.uk/2012/05/18/switzerland-proposes-future-work-by-uncitr…* [Accessed 13 December 2016].

[110] Switzerland proposes future work by UNCITRAL on international contract law", (18 May 2012), para.8, *European Private Law News*, *http://www.epln.law.ed.ac.uk/2012/05/18/switzerland-proposes-future-work-by-uncitr…* [Accessed 13 December 2016].

[111] "Switzerland proposes future work by UNCITRAL on international contract law", (18 May 2012), para.9, *European Private Law News*, *http://www.epln.law.ed.ac.uk/2012/05/18/switzerland-proposes-future-work-by-uncitr…* [Accessed 13 December 2016].

[112] "Switzerland proposes future work by UNCITRAL on international contract law", (18 May 2012), para.11, *European Private Law News*, *http://www.epln.law.ed.ac.uk/2012/05/18/switzerland-proposes-future-work-by-uncitr…* [Accessed 13 December 2016].

[113] Schwenzer, "Who needs a Uniform Contract Law, and Why?" (2013) 58 *Villanova Law Review* 723, 727.

[114] Schwenzer, "Who needs a Uniform Contract Law, and Why?" (2013) 58 *Villanova Law Review* 723, 723.

[115] Schwenzer, "Who needs a Uniform Contract Law, and Why?" (2013) 58 *Villanova Law Review* 723, 723. For a comparison of the CISG and PICC see, e.g., M.J. Bonell, "UNIDROIT Principles of International Commercial Contracts and the United Nations Convention on Contracts for the International Sale of Goods—Alternatives or Complementary Instruments?" [2000] *Business Law International* 91, 94–96.

However, the Swiss Proposal has been met with opposition, with a future direction yet to be confirmed.[116]

The Principles of International Commercial Contracts

The Principles of International Commercial Contracts (PICC) of 2010 is a document drawn up by UNIDROIT, intended to provide a harmonised set of guidelines on international commercial contracts.[117] Like the PACL and PECL, the PICC is a "private codification" prepared by eminent jurists in the field. These principles were compiled to reflect the laws of different legal systems, irrespective of traditions and conditions.[118]

The PICC devotes an entire Ch.3 to the validity of the contract. Article 3.1.1 provides that a "contract is concluded, modified or terminated by the mere agreement of the parties, without any further requirement". In accordance with art.3.1.4, provisions on certain validity factors, including fraud, are mandatory. Section 2 of this chapter deals with the grounds for avoidance, wherein it covers various validity issues including mistake,[119] fraud[120] and gross disparity.[121]

According to the PICC, avoidance for mistake occurs where there is mutual mistake and the mistake was of such importance that a reasonable person in the same situation as the party in error would only have concluded the contract on different terms, or not at all, if the true nature of the mistake had been known.[122] Fraud avoidance occurs where a party has been led to conclude a contract owing to fraudulent misrepresentation, by language or practice.[123] Avoidance for unconscionability (gross disparity) occurs where either the contract or a term of the contract gave a party excessive advantage. Regard must be given to the fact that the party took advantage of the other party's dependence, economic distress, urgent needs, improvidence, ignorance, inexperience or lack of bargaining skill. Regard must also be given to the purpose of the contract.[124]

The above-mentioned requirements reflect a strong resemblance to the corresponding provisions of the PECL discussed previously. For example, both art.3.2.5(1) of the PICC and art.4(107) of the PECL allow for avoidance for misrepresentation on the basis of misleading words or conduct that induced a party to contract.[125] It would therefore seem reasonable to allow for the adoption of the PICC in case of the validity exception. However, despite the international nature

[116] Spagnolo, "Law Wars" (2013) 58 *Villanova Law Review* 623. See also K. Loken, "A New Global Initiative on Contract Law in UNCITRAL: Right Project, Right Forum?" (2013) 58 *Villanova Law Review* 509 (noting that despite a prevailing view during the 45th UNCITRAL meeting (2012) in support of the Swiss Proposal, a number of delegations, including the US delegation, expressed strong reservations about undertaking further work in the area of international contract law).

[117] UNIDROIT PICC, pp.vii–viii. The first edition of the PICC was published in 1994; the second enlarged edition was published in 2004; and the third edition was published in 2010. See PICC (1 August 2014).

[118] UNIDROIT PICC, p.xxiii.

[119] UNIDROIT PICC art.3.2.1.

[120] UNIDROIT PICC art.3.2.5.

[121] UNIDROIT PICC art.3.2.7.

[122] UNIDROIT PICC art.3.2.2(1).

[123] UNIDROIT PICC art.3.2.5(1).

[124] UNIDROIT PICC art.3.2.7(1).

[125] UNIDROIT PICC art.3.2.5(1) and PECL art.4(107).

of the PICC, there has been minimal usage by jurisdictions, and therefore limited development of case law, making it a rare choice in the context of contract law.[126]

Notwithstanding this, the CISG could be revised using the PICC as a point of reference. However, this would take up too much time and hence affect the overall development of the Convention.[127] The more viable option is to use the UNIDROIT principles as a backdrop to both the CISG and domestic laws.[128] Considering that the PICC reflects 14 years of research and discussion, it provides an in-depth analysis on the similar solutions found in many legal systems[129] and fosters an already unified understanding on contract validity.[130]

Importantly, s.2 of Ch.3 of the PICC provides not only a list of validity issues, but it also specifies the criteria for establishing a cause of action and lists the available remedies. Provisions relating to fraud, threat, gross disparity and illegality are mandatory, while provisions relating to mere agreement, impossibility and mistake are not.[131] The PICC also includes comments explaining the concepts/logic behind its provisions, thereby providing useful guidance as well as promoting an understanding of the principles guiding its provisions. Since the PICC's role is one of restatement and as a non-binding set of principles, it would follow that these principles do not strive for enforceability, but rather a global background doctrine.[132] Therefore, while providing guidance, the PICC maintains the freedom of the parties to contract, prompting the PICC to an advantageous path to reform the CISG. The implication for contractual validity relies on the complexity of the method, with the most workable solution to govern the validity of contracts being flexibility between the CISG and the PICC. However, augmenting the CISG with the PICC, in addition to the already existing role of national laws on matters of validity, and possibly some regional agreements, may result in increasing complexity and confusion, which may hinder unification, harmony and predictability.

Future prospects

In the view of the CISG Advisory Council, "[a] key attribute of uniformity and harmonisation is also simplicity".[133] The Council observes that:

> "Increasing legal plurality detracts from that virtue and introduces fragmentation, which is the very thing that uniformity and harmonisation seek to avoid. There is, furthermore, the likelihood that regional initiatives would not produce better solutions and, moreover, that those solutions would

[126] R. Michaels, "The Unidroit Principles as Global Background Law" (2014) 19 *Uniform Law Review -Revue de droit uniforme* 643.

[127] Michaels, "The Unidroit Principles as Global Background Law" (2014) 19 *Uniform Law Review -Revue de droit uniforme* 643.

[128] Michaels, "The Unidroit Principles as Global Background Law" (2014) 19 *Uniform Law Review -Revue de droit uniforme* 643.

[129] Hans van Houtte, "The UNIDROIT Principles of International Commercial Contracts" (1995) 11 *Arbitration International* 373, 373–390.

[130] UNIDROIT PICC, p.xxiii.

[131] UNIDROIT PICC art.3.1.4.

[132] UNIDROIT PICC art.3.1.4.

[133] CISG-AC Declaration No.1, "The CISG and Regional Harmonisation", Rapporteur: Professor Michael Bridge, London School of Economics, London, UK, adopted by the CISG-AC following its 16th meeting in Wellington, New Zealand (3 August 2012), *http://www.cisg.law.pace.edu/cisg/CISG-AC-dec1.html* [Accessed 13 December 2016].

> not have been subject to the same searching inquiry, from delegates drawn from many different countries, as occurred in the case of the CISG."[134]

While regional initiatives are a valuable contribution to the harmonisation of commercial law, so far as they vary, they do not promote the cause of harmonisation and as such thus pose a danger in a sense that

> "States may become entrenched behind regional instruments at the expense of participating in the work of *increasing* harmonisation of global contract law that has yet to be done to carry forward the achievements of the CISG".[135]

Future work needs to be focused on the areas of global contract law falling outside the CISG. As far as the validity exception to the CISG, as one such area, is concerned, the above-discussed approaches could be combined in order to be incorporated into the CISG, so that they provide for a comprehensive coverage of this issue. Alternatively, only specific concepts of contract validity could be considered.

The comprehensive approach

One way to change the status quo would be to adopt a protocol to the CISG. A protocol defining validity and providing a non-exhaustive list of validity issues would make the CISG more comprehensive and relevant, as well as reduce the level of complexities arising from the exclusion. Defining the term "validity" would not only widen the scope of the CISG, and its capacity to resolve disputes, but it would also diminish the divergent results and uncertainties that arise from disparate decisions in different legal jurisdictions subject to different laws and interpretations. A uniform definition would provide a uniform law, lessen the impact of forum-shopping, reduce the costs of legal research and promote certainty and public policy. The inclusion of a non-exhaustive list of validity issues would provide adjudicators with the understanding and tools necessary for more uniform resolution, and ultimately promote unification and harmonisation.[136] A more comprehensive CISG that addresses validity issues would also contribute toward the development of appropriate commercial law regimes in developing states, as well as enable adjudicators in such states to consider public policy issues at the international level and, hence, promote equal treatment for developing states.[137]

Michael Lopez has proposed a sample of a revised art.4 of the CISG.[138] His proposal provides for a non-exhaustive list of the validity issues in art.4 of the CISG. This proposal also highlights the international character of the CISG and the principles espoused by the United Nations Charter and the International Bill

[134] CISG-AC Declaration No.1, "The CISG and Regional Harmonisation" (3 August 2012), para.4.

[135] CISG-AC Declaration No.1, "The CISG and Regional Harmonisation" (3 August 2012), para.4 (emphasis in original) and para.5 (observing that "only three States that are parties to the OHADA law are also CISG Contracting States").

[136] Lopez, "Resurrecting the Public Good" (2010) 10 *Journal of Business and Securities Law* 133, 166. See also U. Magnus, "CISG v CESL" in U. Magnus (ed.), *CISG v Regional Sales Law: With a Focus on the New Common European Sales Law* (Munich: Sellier, 2012), p.97 at p.122.

[137] Lopez, "Resurrecting the Public Good" (2010) 10 *Journal of Business and Securities Law* 133, 166–167.

[138] Lopez, "Resurrecting the Public Good" (2010) 10 *Journal of Business and Securities Law* 133, 168. For a discussion on the subject of amending the CISG see also, D. Sim, "The Scope and Application of Good Faith in the Vienna Convention on CISG" in Pace International Law Review (ed.), *Review of the Convention on Contracts for the International Sale of Goods 2002–2003* (Kluwer Law International, 2004), p.19.

of Rights that inform the CISG and its workings.[139] Lopez explains that "courts should be on notice that public policy *is* an issue that informs the CISG and validity findings under its auspices",[140] and that moreover there are relevant tools to be applied, as well as other relevant international legal instruments to be taken into account.[141]

The specific concept approach

The incorporation of contract validity in its entirety into the CISG could take up considerable time and resources. Professor Eiselen suggests that it would be more feasible to identify significant areas of law that require attention (as discussed at the CISG Basel Conference).[142] For example, common grounds for rescinding a contract fall under mistake and fraud.[143] Rescinding a contract on the ground of unconscionability has been adopted by French law and the UNIDROIT PICC.[144]

Contract avoidance, fraudulent misrepresentation and mistake in domestic laws are said to overlap with the CISG's avoidance rule,[145] set out in art.49(1), pursuant to which a fundamental breach may result in contract avoidance.[146] Nevertheless, the concept of mistake under certain national laws still allows for avoidance for "*any* mistake in relation to the quality of goods", which is contrary to the fundamental breach rule in the CISG,[147] and hence can be seen as undermining the avoidance rule within the CISG.[148] It has also been noted that arbitrators' restraint to exercise domestic validity rules is mainly concerned with upholding the uniform Convention and the remedial solutions in it.[149] In order to avoid divergent outcomes (due to the various laws of domestic legal jurisdictions), arbitrators must exercise restraint and look to the CISG. This, however, does not mean that adjudicators should allow the CISG to dismiss domestic laws designed to prevent unfairness.[150] Balancing between the two would be a stepping-stone towards the harmonisation of the international law governing contracts for the sale of goods.

Summary

The absence of validity from the scope of the CISG has prompted efforts by different regions of the world, and by individual state parties to the CISG, to fill the gap. In particular, Asia and Europe, sharing the highest percentage in

[139] Lopez, "Resurrecting the Public Good" (2010) 10 *Journal of Business and Securities Law* 133, 168.

[140] Lopez, "Resurrecting the Public Good" (2010) 10 *Journal of Business and Securities Law* 133, 168 (emphasis in original).

[141] Lopez, "Resurrecting the Public Good" (2010) 10 *Journal of Business and Securities Law* 133, 168.

[142] S. Eiselen, "Control of Unfair Standard Terms in International Sales", Paper presented at the Basel Conference on the 35th anniversary of the CISG (2015), pp.11–12, *http://www.cisgbasel2015.com/index_html_files/13_ppt_Sieg%Eiselen.pdf* [Accessed 23 Novemebr 2015].

[143] K. Saare, K. Sein and M.-A. Simovart, "Differentiation of Mistake and Fraud as Grounds for Rescission of Transaction" (2007) 7 *Juridica International Law Review* 142, 142–149.

[144] L. O'Mahony, J. Devenney and M. Kenny, *Unconscionability in European Private Financial Transactions Protecting the Vulnerable* (Cambridge: Cambridge University Press, 2010), p.140.

[145] Lookofsky, *Understanding the CISG* (2012).

[146] CISG art.49(1).

[147] S. Kroll, "Selected Problems concerning the CISG's Scope of Application" (2005) 25 *Journal of Law and Commerce* 25, 39.

[148] J. Fawcett, J. Harris and M. Bridge, *International Sale of Goods in the Conflict of Laws* (Oxford: Oxford University Press, 2005), pp.906, 947.

[149] Lookofsky, *Understanding the CISG* (2012), pp.41–42.

[150] Lookofsky, *Understanding the CISG* (2012), p.43. See also L. Graffi, "Case Law on the Concept of 'Fundamental Breach' in the Vienna Sales Convention" [2003] *International Business Law Journal* 338.

merchandise trade, have generated and introduced uniform model laws for their respective regions.[151] The PACL and the PECL are private initiatives aimed at reforming matters outside the scope of the CISG in order to promote consistency and uniformity at the regional level. The drive for uniform laws within both regions demonstrates a strong move towards a uniform law text, currently only partially achieved by the CISG. Although the model laws have no direct impact on the CISG, these initiatives imply the desirability of the gap-filling guidelines vis-à-vis the CISG. This is further reinforced by endeavours at the international level to harmonise contract law.

While a comprehensive revision of contract validity would be ideal, such an approach has been dismissed. It has been argued that specific concepts of contract validity should be adopted as a more feasible option whereby the CISG would be complemented, inter alia, by the UNIDROIT PICC. To avoid duplication of efforts, further research is required regarding the working relationship between UNCITRAL and UNIDROIT, as well as other players concerned with the harmonisation of contract law, as contractual validity is said to be a substantive carve-out to the CISG, an issue that cannot be readily addressed immediately.

Conclusion

The CISG proclaims uniform rules to govern contracts for the international sale of goods. However, the exclusion of contract validity appears to have undermined the purported purpose of the Convention. Significant validity issues have been relegated to the domestic sphere, which has resulted in divergent decisions reached by adjudicators, thereby leading to inconsistencies and legal unpredictability. The lack of predictability impairs the development of the Convention and repels states' interest in ratifying it.[152]

While it has been claimed that the CISG will continue to lead as one of the major success stories in the field of unification of international private law,[153] there are, nevertheless, issues that warrant attention. Contractual validity is one such issue—still an important gap that needs to be addressed[154]—as evidenced by a serious discussion in Panel Four at the recent Basel Conference.[155] It can be safely concluded that on the CISG's 35th birthday, much-needed harmonisation has only been partly achieved. A key solution to the problem is to reconsider the validity exclusion.

[151] WTO, *World Region Report on Merchandise Trade* (October 2014).
[152] Its current status (85 State Parties) suggests that the CISG is still far away from universal acceptance.
[153] P. Huber, "Some Introductory Remarks on the CISG" (2006) *Internationales Handelsrecht* 228, 228.
[154] Huber, "Some Introductory Remarks on the CISG" (2006) *Internationales Handelsrecht* 228, 228.
[155] M. Wellar, Conference Report CISG Basel Conference, 29 and 30 January 2015, University of Basel (17 February 2015), *Conflict of Laws.net: News and Views in Private International Law*, *http://conflictoflaws.net/2015/conference-report-cisg-basel-conference-29-and-30-january-2015-university-of-basel/* [Accessed 13 December 2016].

Review of the Current Hull Insurance Law of China: Comparison with the UK Rules

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China; Comparative law; Hull and machinery insurance; Insurable interests; Shipping law; Subrogation; Utmost good faith

Abstract

In this article, an in-depth discussion is presented on several key aspects of China hull insurance law, specifically including insurable interest, good faith imposed on both assured and insurer, subrogation and abandonment and controversial issues in standard hull clauses, etc. In China, hull insurance is subject to the provisions of both the China Maritime Code and, in the absence of the provisions in the China Maritime Code, the China Insurance Law, as well as standard insurance clauses. Accordingly, and generally speaking, Chinese hull insurance law can be properly described as a combination of both English law concepts and the civil law tradition. In spite of some key concepts of China Maritime Code being transplanted from the English marine insurance law, caution must be taken to avoid the misunderstanding that Chinese courts would interpret the relevant concepts in line with or following English doctrines or practice. With the knowledge that, basically, the Chinese civil law system has been built up, it is reasonable to say that Chinese hull insurance law, even though it has been modelled, to some extent, on its English-rule counterparts, is now taking a freestanding approach.

General introduction

It is a distinct feature of Chinese insurance contract law that the Chinese Insurance Law (CIL) governs non-marine insurance and the Chinese Maritime Code (CMC) governs, inter alia, marine insurance. The CMC has been in force for about 20 years since its promulgation in 1992 while the CIL has undergone two revisions in 2002 and 2009 although it was enacted in 1995, later than the CMC. In accordance with art.184 of the CIL, the relevant provisions of the CMC shall apply to marine insurance, and for matters not covered by the CMC, the relevant provisions of the CIL shall apply. Accordingly, in this article, both the CMC and CIL would be relevant for a discussion of Chinese law in relation to hull insurance, and the Supreme People's Court's judicial interpretation on marine insurance will also be regarded as legally binding and applied for resolving hull insurance disputes. Generally, the applicable hull insurance clauses should be given priority over legal provisions when a particular hull insurance dispute is to be resolved; for the purpose of presenting a complete picture of Chinese hull insurance law, this article will also analyse some of the controversial Chinese standard hull clauses.

As China has the tradition of a civil law system, cases should have no such binding authority as in common law countries such as the UK. But case study is still necessary for understanding the live or real law in China. For this reason, the authors will try to find suitable cases to make the relevant discussions more convincing and instructive.

Generally speaking, most researchers believe that many concepts adopted in Chinese marine insurance law, in particular in the CMC, are English in origin,[1] such as duty of disclosure and a more comprehensive duty of utmost good faith, subrogation and abandonment, etc., while the CIL, together with the civil law and contract law of China, generally continues to follow the civil law tradition. In the case of standard insurance clauses, however, Chinese hull clauses also more or less modelled upon their English counterparts.[2]

Then, so far as hull insurance is concerned, how can the relevant provisions in CMC or the hull standard clauses be applied properly in the case of possible conflict or even contravention of related Chinese laws? Further, such questions of general interest such as what meaning or interpretation would be given to the concepts or doctrines transplanted from English law in China, and what will be the relationship between China and UK in the hull insurance area, may also be asked.

As the core of marine insurance, broadly speaking, hull insurance may include a variety of types such as hull and machinery insurance, freight and loss of hire insurance, third-party liability (P & I insurance), builders' risk insurance and off-shore structures insurance.[3] For clarification, the hull insurance referred to in this article means hull and machinery insurance only.

As a whole, the relevant hull insurance law in China, which is a part of marine insurance and mainly prescribed in Ch.12 of the CMC and Ch.2 of the CIL, will include a variety of matters.[4] Instead of attempting a complete introduction, the authors wish to concentrate on such distinct issues as insurable interest, good faith, subrogation and abandonment, and standard clauses interpretation, from which controversies often arise in Chinese hull insurance law. By doing so, it is expected that the readers may obtain a proper understanding of these important aspects of Chinese hull insurance law.

[1] See J. Zhen "The Confusion between Subrogation and Assignment in PRC Insurance Law 1995" [2002] J.B.L. 607; X. Wang, "On the Standard of Materiality in the Marine Insurance Laws of PRC and U.K." [2002] *Contemporary Legal Science* 155 (in Chinese); K.X. Li, T. Fu, L. Zhu and Y. Liu, "Marine Insurance Law in China" [2008] 32 Tul. Mar. L.J. 425, 431.

[2] In addition to English ITC Hull Clauses 1983, the Chinese PICC Hull Clauses 1986 also made reference to UNCTAD Model Hull Clauses 1984, Norwegian Marine Insurance Plan, and American Institute Hull Insurance Clauses: see H. Wang, *Hull Insurance Theory, Practice and Management* (Dalian Maritime University Press, 2006), p.18 (in Chinese).

[3] T.-L. Wilhelmson "The Marine Insurance System in Civil Law Countries—Status and Problems", Marine Insurance Symposium Oslo (June 1998), p.11.

[4] For a comprehensive introduction of both the marine insurance contract law and insurance regulatory law in China, see Li, Fu, Zhu and Liu, "Marine Insurance Law in China" 32 Tul. Mar. L.J. 425.

Insurable interest

The requirement for an insurable interest emanates from a cardinal principle of marine insurance law that a contract of marine insurance is a contract of indemnity. So far as the property insurance, of which hull insurance is part, is concerned, art.12 of the CIL provides, inter alia, that:

> "The assured under property insurance shall, when an insured event occurs, have an insurable interest in the subject matter insured. The 'insurable interest' shall refer to a legally recognized interest of the proposer or the assured in the subject matter insured."

Article 38 of CIL further provides that

> "if an assured has no insurable interest in the subject matter insured when an insured event occurs, he is not allowed to claim insurance indemnity from the insurer".

As there are no express provisions in CMC addressing insurable interest, in principle, these provisions will be applied to a hull insurance case. However, the nebulous term "legally recognised interest" has brought difficulties to both academic circles and judicial practice on whether a broad or strict interpretation should be given to the definition.

It is surmised by research on the development of insurable interest provisions in China that the legal standard of insurable interest in the CIL should share the same approach adopted by Germany and also similar to MIA 1906, that is, the assured can only have insurable interest when he has both legal rights to and economic interests in the subject-matter insured.[5] Because of the controversy and inconsistent opinions on this subject, the application of the insurable interest requirement would possibly be up to the discretion of the courts hearing particular disputes.

Only one Chinese maritime court has ever held that only the owner of the insured subject-matter can be the assured and has the insurable interest. However, such an opinion is obviously inconsistent with business practice and even contrary to the express provision of the CMC. For example, art.148 of the CMC provides that a ship under bareboat charter shall be insured by the charterer at his expense at the value agreed upon in the charter and in the way consented to by the ship owner; and art.15 thereof provides that if the ship under mortgage is not insured, the mortgagee has the right to place insurance for the ship and the mortgagor shall pay for the premium thereof. As the right or interest of bareboat charters and mortgagees to hull insurance are clearly recognised by the CMC, there are no reasons for courts to deny the insurable interest of such parties in the ship concerned. Indeed, in most hull insurance cases, the insurable interest of the ship manager, operator or bareboat charterer have been sustained by the courts,[6] and

[5] See H.Y. Yeo, Y. Jiao and J. Chen, "Insurable Interest Rule for Property Insurance in People's Republic of China" [2009] J.B.L. 776, 785–789.

[6] See hull insurance dispute cases such as MV *Rongsheng*, Case No.(1998) Lujingzhongzi 533 (manager and beneficial owner); MV *Yuhang*, Case No.(1998) Dahaifashangchuzi 123 (bareboat charterer); MV *Weiyang*, Case No.(1998) Lujingzhouzi 639 (bareboat charterer); MV *Xiangrun*, Case No.(2009) Qinghaifahaishagnchuzi 353 (ship manager). But there are also minor decisions denying the ship management company's insurable interest on domestic ships such as the MV *Shengjifa 68* and MV *Xinghai* cases cited in P.N. Wang (ed.), *Abstracts and Comments on Chinese Marine Insurance Cases*, Vol.2 (Dalian Maritime University Press, 2008), pp.26 and 30 (in Chinese).

currently the courts would commonly hold that the assured has an insurable interest unless it can be established that the assured has some contractual relationship or business arrangement with the ship owner in relation to the ship and therefore would suffer losses by reason of insured events, so there should be not much difficulty in hull insurance determining the existence of insurable interest.

The more complicated and unsettled issue in China judicial practice, however, seems to be that since the insurable interest of the non-owner assured is in theory distinct from that of the owner in both nature and measure of value, it is questionable whether the non-owner should be entitled to claim and retain the full extent of the loss or damage of the ship. In English law, it is recognised that a person with a partial interest in the subject-matter insured (so called "pervasive insurable interests") may insure the same subject-matter on behalf of another person with an interest therein, and for the considerations of commercial convenience, the assured will be entitled to recover the full extent of any property loss but subject to an account to the true owner of the property.[7] For example, a mortgagee, consignee or other person with similar interest may insure not solely for his own benefit but also on behalf and for the benefit of other persons interested.[8] Although there is no such provision in Chinese law, it seems that, in hull insurance cases where the assured is not the owner of the ship, Chinese courts take it for granted that the assured is entitled to the full amount of compensation for the loss of or damage to the ship without inquiry whether such amount corresponds with the insurable interest of the assured or not. Such a pragmatic and liberal approach may be problematic in terms of law and unaccountable to the possible argument of the insurer that the non-owner insurer should only be indemnified to the extent of its lost interest in the ship (rather than the actual value of the loss or damage). It is proposed that this issue should be clarified by judicial interpretation to the effect that the assured, if not being owner of the ship, may still insure the full value of the ship for the interests of both the owner and himself and, in the case of the insured event, claim for the loss or damage, holding the insurance indemnity over its own interest for the sole benefit of the owner. Accordingly, such indemnity in excess of the assured's own interest is not the asset of the assured, thus should not be subject to seizure or attachment by the assured's creditors. Alternatively, the assured may list the registered owner, bareboat charterer (if any), manager or operator of the ship as co-assured so as to avoid the dispute of insurable interests.

Good faith

Although many scholars believe that utmost good faith is one of the important concepts in Chinese marine insurance law transplanted from the English law, there is no such provision in the CMC as s.17 of the MIA 1906, which has been recently revised by s.14 of the Insurance Act 2015.[9] It seems that the equivalent in Chinese law, if any, appears in art.5 of the CIL, providing that the parties to insurance

[7] P. M. Eggers "The Marine Insurance Act 1906: Judicial Attitude and Innovation—Time for Reform?", Ch.10 in D. Rhidian Thomas (ed.), *Marine Insurance: The Law in Transition* (London: Informa, 2006), p.199.
[8] MIA 1906 s.14(2).
[9] MIA 1906 s.17 provides that "a contract of marine insurance is a contract based upon the utmost good faith, and, if the utmost good faith be not observed by either party, the contract may be avoided by the other party", while the s.14 of the Insurance Act 2015 repeals the concluding section of s.17 to retain the bare statement that a contract of marine insurance is one of the utmost good faith. The Insurance Act 2015 came into effect as from 12 August 2016.

activities shall abide by the principle of good faith when exercising their rights and performing their obligations. As CIL generally follows the civil law concept and approach, it is doubtful whether the common law concept of utmost good faith will be reconciled with the principle of good faith and the related provisions in CIL.

That said, to formulate the duty of disclosure in marine insurance, it seems clear that the assured's duty of disclosure in ss.18–20 of the MIA 1906 has been closely modelled upon by the CMC, although the relevant English law is now respectively replaced by a single duty to take reasonable care to avoid misrepresentation in the Consumer Insurance (Disclosure and Representations) Act 2012 for consumer insurance and a new duty of fair presentation by s.3 in the Insurance Act 2015. On the part of Chinese law, it suffices to say here that the duty of disclosure in the CMC has great differences from its counterpart in the CIL.[10] As a result, the inherent differences in disclosure requirements between marine and non-marine contracts are likely to give rise to irreconcilable difficulties when dealing with, for example, the insurance coverage of yachts or small family-owned boats, etc., but such difficulties will not be encountered in the case of ocean-going hull insurance discussed in this article.

In addition to the assured's duty of disclosure, the insurer is under a unique duty to explain under the CIL, which is also deemed as a part of good faith required by the CIL but very different from the duty of disclosure of the insurer under English law.

To sum up, so far as hull insurance is concerned, both the assured's duty of disclosure and the insurer's duty to explain are important parts of the principle of good faith, respectively provided for in the CMC and CIL, and the former is similar to the MIA 1906 before it was revised by the Insurance Act 2015 (but the legal consequence for breach is very different) while for the latter there seems no equivalent provision in English law.

Assured's duty of disclosure

It is provided in art.222 of the CMC that before a contract is concluded, an assured shall truthfully inform the insurer of material circumstances which the assured has knowledge of or ought to have knowledge of in the ordinary course of business and which may influence the insurer in fixing the premium or determining whether he agrees to insure.

From the wording "in the ordinary course of business", which apparently may be transplanted from s.18 of the MIA 1906,[11] it may be implied that this duty only applies to the business insurer rather than consumer insurance, such as insurance for a family-owned yacht or small boat which will not be involved in business. Although it is understood that in the UK, instead of the MIA 1906, now the Consumer Insurance (Disclosure and Representations) Act[12] in relation to consumer insurance would be applied to such private ships, it is not beyond dispute that, for

[10] The difference and comparison of the assured's duty of disclosure in the CMC and CIL are beyond the scope of this article; for detail, please refer to J. Zhen, "Insured's Duty of Disclosure and Test of Materiality in Marine and Non-Marine Insurance Laws in China" [2006] J.B.L.681 and H.Y. Yeo, Z. Yu and J. Chen, "Of Remedies and Non-disclosure in the Insurance Law of the People's Republic of China" [2011] J.B.L. 556.

[11] In English law, this section is repealed by the Insurance Act 2015.

[12] The Act came into force on 6 April 2013.

the insurance of such a private ship as a yacht, the duty of disclosure in the CMC or in CIL will be applied. In our opinion, however, the insurance for a yacht which can be classified or qualified as a ship under the CMC,[13] whether it is used for private or business purposes, shall be subject to the provisions of the CMC rather than those of the CIL, and in such a case the wording "in the ordinary course of business" in the CMC should not be interpreted literally.

It should be noted that, similar to s.3 of the Insurance Act 2015, art.222 of the CMC combines both the disclosure and representation in one article to the effect that "truthfully inform the insurer of material circumstances" should require both disclosure of material circumstances on the assured's own initiative, and true representation of material circumstance. For the test of materiality for circumstances, it is suggested by Chinese scholars that a decisive influence upon a prudent insurer should be applied.[14]

The most remarkable difference between the CMC and the MIA, as well as s.3 of the Insurance Act 2015 in respect of the duty of disclosure is the remedy for breach of the duty. Briefly speaking, art.223 of the CMC entitles the insurer to cancel the contract for the future; and for intentional breach the assured will be deprived of all the rights under the contract while for unintentional breach the liability of the insurer will only be discharged as from the time of cancelation unless the breach has bearing on the occurrence of the event insured, in which case the insurer shall not be liable for the loss caused thereby.

Although it seems clear from the provisions of the CMC that the scope of the assured's disclosure should be dependent on the materiality of circumstances in the eyes of prudent insurer and not be confined to the inquiry of the insurer, it seems that disputes as to the extent to which the duty should be performed may still arise in particular hull insurance cases. For example, in one hull insurance case,[15] the plaintiff assured entered into an insurance contract with the defendant insurer to cover the towage of a retired submarine from Dalian to Zhenjiang. During the course of the conclusion of the insurance contract, the agent of the assured stated the general conditions of the submarine in writing to the insurer and presented a certificate of seaworthiness offered by the seller, a navy unit. Eventually, an insurance policy for towage of the submarine was issued. The submarine sank unfortunately two days after it set off with the tug. The insurer refused the claim of the assured on the grounds, inter alia, that the assured breached the duty of disclosure by not disclosing that the submarine had neither acquired documents of registration nor applied for towage inspection.

The first instance court held that the assured has performed his duty of disclosure by providing the general situations of the submarine in writing and the certificate of seaworthiness and it was not proven by the insurer that the fact that the assured had not proceeded with registration and applied for towage inspection caused the sinking of the submarine, so the insurer should be liable for the loss of the

[13] According to art.3 of CMC, "ship", as referred to in this Code, means seagoing ships and other mobile units, but does not include ships or crafts used for military or public service purposes, or small ships of less than 20 tons gross tonnage.

[14] Wang, *Theory and Practice of Modern Marine Insurance Law* (2004), p.43 (in Chinese); Wang, "On the Standard of Materiality in the Marine Insurance Laws of PRC and U.K." [2002] *Contemporary Legal Science* 155 (in Chinese).

[15] *Ship Affair Company of Taixing Municipality v Pacific Insurance Company (Shanghai) Ltd. of China*, cited from The Chinese Institute for Practical Legal Research of the Supreme People's Court (ed.), *Selected Cases of the People's Court*, Vol.23 (Beijing: Publishing House of People's Court, 1998), pp.255–261.

submarine. The insurer lodged an appeal and the appellant court dismissed the appeal, holding that the conditions of the retired submarine had been disclosed before the issuance of the insurance policy and that the insurance contract had been concluded on the basis of the true intention of both parties and therefore was legally formed. Accordingly, the appellant court appears to take the view that the assured has not breached his duty of disclosure in this case.

In our opinion, the decisions made by both courts are fair and reasonable. At first glance, the allegation of the insurer seems plausible because, according to Maritime Traffic Safety Law of PRC, before the towage of the submarine in this case, the towage inspection should be conducted by the ship survey authority. Without applying for the inspection before the towage, the assured actually breached this administrative regulation. The assured also did not register the submarine as a civilian ship after its retirement from navy services as required by relevant regulation. So, it appears justified to argue that the assured breached the duty of disclosure for non-disclosure of such material circumstances. In this case, however, the argument of the insurer was rejected by both courts. The views of the courts inferred that the insurer, who has his own duty to assess the risk, should not completely rely on the assured's initiative to provide any information that the insurer knew or ought to have known in the course of normal business as well. Presumably, the courts took the view that the insurer knew or ought to have known the matters as to registration and towage inspection at the time of negotiation of the contract, and that if the insurer was concerned with such matters at that time, he should have made further inquiries about them.[16] The fact that the insurer did not make any further inquiries indicates that the insurer had accepted the risk on the basis of the disclosure which had been made by the assured and he was not entitled to rely on the facts ignored or waived by him later as a ground of non-disclosure. In another hull insurance dispute,[17] before the conclusion of the contract, the assured did not make any false representations and had invited the insurer to survey the conditions of the subject-matter on the spot. However, the insurer failed to conduct the on-the-spot survey. It was the opinion of the Supreme People's Court that the insurer had no right to refuse the compensation on the ground of non-disclosure. The court appears to accept that the insurer is also obliged to assess the risk positively when the assured discloses or represents the conditions of the subject-matter insured; if the insurer or its employee fails to conduct some investigations about the risk, his omission to investigate will probably constitute a waiver to the further circumstances which could have been ascertained by the investigations and his allegation of non-disclosure afterwards will not be accepted by the court, especially where the assured is unclear about what circumstances should be disclosed and asks the insurer to ascertain them by himself.

[16] Indeed, according to art.222(2) of the CMC, the assured need not disclose to the insurer a circumstance of which the insurer has or ought to have knowledge in the ordinary course of business and about which the insurer makes no inquiry. Presumably this provision follows s.18(3)(b) of the MIA to the effect that any circumstance which is known or presumed to be known to the insurer need not be disclosed in the absence of inquiry of the insurer.

[17] See B. Changjiu (ed.), *A Practical Guide to Insurance Law* (Hehai University Press, 1996), pp.234–235 (in Chinese); although this case was decided before the promulgation of the CMC, the reasoning of the Supreme People's Court should still be good when the CMC is applied.

Insurer's duty to explain

Although at common law the insurer in certain cases may be subject to a duty of disclosure to the assured,[18] which is also a reflection of the duty of utmost good faith formulated by s.17 of the MIA 1906 and revised by s.14 of the Insurance Act 2015 without any stated remedy, there is no express provision in the MIA 1906 or the Insurance Act 2015 for the insurer's duty of disclosure, and the cases in this respect are also quite limited. In the similar vein, there is no duty of disclosure of the insurer provided in the CMC. However, the CIL imposes on the insurer a duty to explain to the proposer the meaning of standard insurance clauses and in particular the clauses exempting insurer's liability.

Article 17 of the CIL provides that if standard clauses provided by the insurer are used when concluding an insurance contract, the proposal form provided to the proposer (i.e. the prospective assured) by the insurer shall have the standard terms attached thereto and the insurer shall explain the provisions of the contract to the proposer. The same article further provides that the insurer shall, when concluding an insurance contract, provide a reminder on the proposal form, insurance policy document or other insurance certificate sufficient to draw the attention of the proposer to the clauses that exempt the insurer from liability, and shall expressly explain the contents of such clauses to the proposer in writing or orally. If no such reminder or express explanation is given, such clauses shall have no effect. Such provisions are intended to prevent the abuse of unfair standard clauses by insurers and to protect the interests of the assured, and may also be regarded as a reflection of the requirement of good faith in the CIL.[19] As mentioned, the CIL shall be applicable to marine insurance unless the CMC provides otherwise, and because there is no equivalent provision in the CMC, the above provisions shall be applicable to the marine insurance including hull insurance as well as life and non-marine insurance property insurance.

There are two points to be noted in the provisions. First, before the amendment of the CIL in 2009, the clauses which the insurer had to expressly explain were worded as "exemption clauses"; the current wording "the clauses that exempt insurer's liability" is clearly larger in scope and will include but not limit to the former one. For example, a warranty clause in standard hull clauses is not an exemption clause so need not be explained by the former provision but will constitute a clause exempting insurer's liability which shall be expressly explained under the current provision. Secondly, the scope of duty to expressly explain does not extend to clauses defining the insured risk or event. For example, the insurer is not required to expressly explain the meaning of "self-combustion" as an insured risk even if the assured's understanding thereof is different from the definition in the clauses, but if "self-combustion" is listed as a exemption or exclusion clause, it must be explained, according to the CIL. Anyway, if the insurer can prove that the assured has been aware of the meaning of clauses exempting the insurer's liability, explanation of such clauses is not required, and under art.17 of the CIL, the insurer is also not obliged to advise the prospective assured whether the scope

[18] See *Banque Keyser Ullmann SA v Skandia (UK) Ins Ltd* [1987] 1 Lloyd's Rep. 69 Ch D; [1988] 2 Lloyd's Rep. 513 CA (Civ Div); [1990] 2 Lloyd's Rep. 377 HL.

[19] S. Jilu, *The Insurance Law* (Beijing: Legal Affairs Press of China, 1997), p.107.

of standard hull clauses are suitable to cover the risks of the particular subject-matter insured.[20]

In Chinese judicial practice, the insurer's duty to explain in the CIL is commonly invoked against the insurer in cases of vehicle insurance and life insurance disputes, and in such cases the CIL provisions are generally interpreted by courts very literally so that the standard clauses must be actually explained by insurers and mere signature by the proposer on a document confirming the relevant clause has been explained and understood is not enough to make them binding on the proposer. And the court seems to adopt the same approach when applying this duty in the case of marine insurance. In a marine cargo insurance case, for example, the first instance and the appeal courts unanimously held that the insurer failed to prove the exemption clauses in the policy had been expressly explained to the assured, and thus the exemption clauses should have no effect.[21] In a hull insurance case,[22] the court similarly held that the insurer failed to explain the unseaworthiness exemption clause in the standard policy clauses expressly, so that clause had no effect. But fortunately, in both cases, the insurers were still allowed by the courts to invoke the statutory exemptions of cargo and hull insurance as provided in the CMC.

Although the purpose of insurers' duty to explain in the CIL is to prevent the abuse of standard clauses by insurers to unfairly exempt their liability, such provisions, in particular when applying to marine insurance literally, will cause considerable uncertainties and may even encourage the technical defence of assureds, not to mention that they will increase the transaction costs of insurers and eventually prejudice the interests of assureds. It is submitted that the duty to explain provisions in the CIL should be substituted by the more reasonable and interest balancing provisions in the Chinese Contract Law.[23] Regretfully, the provision remains even after amendment of the CIL in 2009, even becoming stricter against insurers, and the court will be unlikely to ignore or abandon the same in hull insurance cases, so the hull insurers are reminded to take precautions against such an extraordinary duty.

Subrogation and abandonment

Article 252 of the CMC provides that

> "where the loss of or damage to the subject matter insured within the insurance coverage is caused by a third party, the right of the assured to demand compensation from the third party shall be subrogated to the insurer from the time the insurance indemnity is paid".

[20] See MV *Royal Aleutian* hull insurance dispute, Second instance civil judgment of Tianjin High People's Court, Case No.(2008) Jingaominsizhongzi 58 (in Chinese).

[21] See Guangzhou Maritime Court Case No.(2005) Guanghaifachuzi 211; and Guangdong High People's Court Case No.Yuegaofaminsizhongzi 304 (in Chinese).

[22] See MV *Zheshaohai No.3* hull insurance dispute, second instance Case No.(2001) Zhejingerzhongzi 105.

[23] See X. Wang and L. Chen, "Some Duties of Marine Insurers in Chinese Law—viewed against the background of related English law", Proceedings of the 4th International Conference on Maritime Law by China Maritime Law Association, 2000, Shenzhen, pp.189–191.

This is regarded as the provision of the insurer's subrogation right in marine insurance (including hull insurance) law. There is a similar provision in art.60 of the CIL, stating that

> "where an insured event occurs due to damage to the subject matter insured caused by a third party, the insurer may, from the date of payment of indemnities to the assured, exercise the assured's right to claim compensation from the third party by subrogation within the amount of indemnities."

It is well established that, under Chinese law, the insurer may automatically acquire and exercise the subrogation right against a third party once the insurance indemnity is paid to the assured.[24] But the nature of the subrogation right is in dispute in academic circles, namely whether the assured's right is assigned to the insurer by operation of law (statutory assignment) or the insurer is only subrogated to the assured's right. In the former case, the subrogation right should be the insurer's own and new right independent of the assured's original right,[25] while in the latter case the subrogation right remains that of the assured.[26] According to relevant provisions of the Maritime Special Procedure Law (MSP) and the CIL, the subrogation right shall be exercised in the name of insurers,[27] and if after the insurer has paid indemnity to the assured, the assured, without the consent of the insurer, waives his right to claim compensation from the third party, such a waiver shall be deemed invalid.[28] Thus the authors take the view that, upon payment of indemnity, the assured's right against the third party shall be assigned to the insurer by operation of law so that it can be exercised by the insurer at his own will and its exercise cannot be waived or the manner of its exercise cannot be agreed by the assured without consent of the insurer. Probably for this reason, it seems to be accepted by many Chinese courts that the insurer, when exercising the subrogation right, may select to resolve the claim by litigation rather than being bound by the arbitration agreement between the assured and the third party on the ground that arbitration should be subject to will autonomy of the parties.[29] On the other hand, where the insurer brings a lawsuit for its subrogation right, it may often be disputed whether the insurer shall be subject to the assured's time-limit counting from a date much earlier than the insurer's acquisition of subrogation right, or enjoy a new time-limit counting from the time when the insurer acquires the subrogation right. According to a recent reply of the Supreme People's Court of China, the time-limit should be counted from the time when the assured should exercise its right as required by Ch.13 of the CMC.[30] As a time-limit defence should be a matter of substantive law, this reply may also support our proposition that the substantive

[24] Such an understanding may be not only established from the wording of both the CMC and the CIL but also confirmed by arts 93 and 96 of the MSPL and art.68 of the judicial interpretation of MSPL.

[25] In this case, however, it does not mean that the subrogation right of the insurer has nothing to do with the assured's original right. In our opinion, the substance (content) of both the subrogation right and the assured's right from which the subrogation right is derived should be the same, but the form of the two rights is distinct. Therefore, the insurer shall enjoy procedural rights, independent of the assured's action or inaction, in legal proceedings, while the substantive rights of the insurer in legal proceedings should be subject to those of the assured.

[26] For example, under English law, the insurer is deemed to step into the shoes of the assured and should only exercise the subrogation right in the name of the assured.

[27] See MSPL art.94.

[28] See CIL art.61(2).

[29] In China, the validity of an arbitration agreement against the subrogated insurer has been a hotly debated issue for a long time, which is not yet finally resolved for the time being.

[30] FASHI [2014] No.15; see *http://www.court.gov.cn/zixun-xiangqing-13621.html* [Accessed 13 December 2016].

aspect of the insurer's subrogation right should be subject to that of the assured's right.

There are also some unresolved procedural issues which may relate to the nature of subrogation right, such as, in spite of the provision of art.95 of MSPL that the insurer in exercise of subrogation right may apply the court for an alteration of the party when the assured has already brought the lawsuit, whether or not the insurer is free to bring a lawsuit in another competent court in exercise of his subrogation right. How and to what extent will the insurer's subrogation right be subject to the assured's conduct when the subrogation right is exercised after the assured has brought a lawsuit against a third party for the same right?[31] We shall have to wait for further judicial cases or interpretation to resolve such issues.

Another recurrent issue related to subrogation is whether the third party may challenge against the subrogated insurer that the indemnity is not within the insurance coverage of the hull policy. Considering the wording of art.252 of the CMC, art.93 of the MSPL and art.60 of the CIL, the loss of the assured within the insurance coverage seems to be an essential element to the subrogation right under Chinese law. However, it seems to be predominant in Chinese judicial practice that where the loss is within the insurance coverage is doubtful or ambiguous and the insurer has indemnified the assured for such loss, the insurer should still be entitled to exercise the subrogation right against the third party. In our opinion, the above view should be the reasonable interpretation of the law on the ground that, first, it is in the public interest against unnecessary litigation and encourage insurers to pay or settle the disputed insurance claims; secondly, it should not be open to a third party to raise a defence which is based on an insurance contract to which he is not a party, a defence which the parties to the contract have chosen not to raise and did not intend for the benefit of the third party (otherwise the third party will enjoy the benefit of insurance even without the costs of paying premium); thirdly, it is public policy to make third parties as wrongdoers pay for the loss which they are responsible. However, if it can be established that the loss of the assured was obviously not covered under the insurance contract and the same was voluntarily paid by insurer, it is submitted that the insurer should acquire no subrogation right in the light of both the CMC and the CIL since voluntary rather than obligatory payment cannot lead to the statutory subrogation right. But, in such cases, the insurer should be entitled to claim against the third party on the basis of assignment as agreed by insurer and assured because there is no general provision under China law prohibiting such assignment and the third-party wrongdoer is not justified to excuse his liability merely owing to voluntary payment to the assured. Anyway, this issue now seems to have been largely resolved because art.14 of the Judicial Interpretation of the Supreme People's Court on Marine Insurance provides that the court entertaining the subrogation action by the insurer shall only adjudge the legal relations between the third party and the assured with respect to the claim. According to this interpretation, the arguments raised by the

[31] Article 67 of the judicial interpretation of the MSPL provides that the insurer, when exercising the subrogation right by joining the proceedings brought by the assured, may benefit from the security obtained by the assured before but should not bear the unfavourable result due to the assured's own fault. There seems no reason why the insurer may enjoy the advantage while in the same case repudiate the disadvantage, both of which were brought about by the assured.

third party related to the validity of insurance indemnity should be considered irrelevant and in effect untenable by the court.

Abandonment is a concept closely related to principle of indemnity and subrogation. Article 249 of the CMC provides that where the subject-matter insured becomes a constructive total loss and the assured demands a total loss indemnity from the insurer, the subject-matter shall be abandoned to the insurer. The insurer may accept or refuse the abandonment, but shall inform the assured of his decision on whether to accept the abandonment within a reasonable time. Article 250 of the CMC provides that where the insurer has accepted the abandonment, all rights and obligations relating to the property abandoned are transferred to the insurer. It is also stated in the standard hull clauses for ocean-going ships that

> "measures taken by the assured or the Insurer with the object of averting or minimizing a loss which would be recoverable under this insurance shall not be considered as waiver or acceptance of abandonment or otherwise prejudice the rights of either party".[32]

It appears that these provisions and standard clauses in relation to abandonment are generally consistent with the English law and practice. One of the minor differences is that the CMC requires the insurer to inform the assured of his decision on whether to accept the abandonment within a reasonable time (without mentioning the legal consequence of failure to inform), while s.62(5) of the MIA provides that "the acceptance of an abandonment may be either express or implied from the conduct of the insurer. The mere silence of the insurer after notice is not an acceptance". In a complicated hull insurance case heard by the Supreme People's Court,[33] which may be regarded as a leading case in respect of abandonment and constructive total loss, it is accepted by both the first and the second instance courts and confirmed by the Supreme People's Court that, where the insurer does not in a reasonable time inform the assured whether to accept the abandonment or not upon receipt of the notice of abandonment, the insured shall be held to have impliedly refused to accept abandonment, and thereby the insurer shall not be entitled to acquire the right to the subject matter insured. It can be concluded from the case that although art.256 of the CMC allows the insurer to acquire the full right to subject-matter insured by paying the full insured amount, the insurer's express or implied refusal to accept abandonment in the case of constructive total loss claim will deprive him of the right to acquire the proprietary right to the ship, but such a conclusion shall not contravene the principle of indemnity,[34] so the insurer may still deduct the wreck value of the ship from payment of the insured amount for a total loss.

[32] The same wording appears in cl.13 duty of assured (sue and labour) of the ITC Hull Clauses 1983.

[33] See MV *Rongsheng* hull insurance dispute Case No.(2011) Mintizi 249, published in the *Gazette of the Supreme People's Court*, Issue No.11 (2012) (in Chinese).

[34] The principle of indemnity is directly reflected in art.216 of the CMC, which provides that a contract of marine insurance is a contract whereby the insurer undertakes, as agreed, to indemnify the loss of the assured caused by perils covered by the insurance against the payment of an insurance premium by the assured. Article 2 of the CIL has similar provision as well.

Some key issues in Chinese standard hull clauses

As mentioned, apart from the relevant legal provisions, the standard hull clauses commonly used in China also constitute an important part of hull insurance law of China. In China, such standard clauses for ocean-going ships are the Chinese PICC Hull Clauses 1986 and have been subject to some amendment in 2009 owing to the amendment of the CIL in the same year.

The full discussion of the hull clauses of China may deserve a separatearticle; here we will focus on two often-debated clauses, i.e. the collision liability and the unseaworthiness exclusion clauses on the basis of current version of PICC Hull Clauses 2009.

In PICC Hull Clauses 2009, the collision liability is a part of all risks coverage but not included in the total loss-only coverage; thus if the ship is covered under total loss only, it cannot be covered for collision liability unless an additional coverage of collision liability is placed.

What the collision liability clause of PICC Hull Clauses 2009 covers is "legal liabilities of the assured as a consequence of the insured ship coming into collision or contact with any other ship, or any object, fixed, floating or otherwise", different from the ITC Hull 1983, in that the latter only applies when such payment by the assured by reason of his becoming legally liable by way of damages "in consequence of the ship hereby insured coming into collision with any other ship". It is clear that the Chinese collision liability clause involves not only the liability for ship collision, which the English clause covers, but also the liability for contact with any fixed or floating objects (FFO) by the ship. Another difference in the scope of coverage is the Chinese clause covers full liability of the assured for ship collision or contact including legal costs subject to the insured amount in respect of each separate occurrence, while the English clause is only responsible for three-fourth of the insured value of the ship as well as three-quarters of the sums paid by the assured in respect of any one collision.

What is unclear from the wording of the Chinese clause is meaning of the "in collision with any other ship". In the famous case of *Fushan*,[35] the Supreme People's Court takes the view that the wording of the clause is ambiguous so that the collision therein should be interpreted against the insurer and includes both physical and non-contact collision. Such an understanding seems to be different from the English common law and practice, according to which a collision can only occur where two or more ships, including the ship's apparel or structure, have actual contact.[36] As a result of such a view of the court, insurers will have to incorporate special clauses excluding the liability and costs therefrom for non-contact collision in the hull policy if they do not want to cover it. With respect, the authors are of the opinion that the view of the Supreme People's Court could be problematic. Because art.165 of the CMC clearly defines "collision" as "an accident arising from the touching of ships at sea or in other navigable waters adjacent thereto"

[35] MV *Fushan* collision liability clause dispute Case No.(1999) Qinghaifashangchuzi 180 (first instance) and Case No.(2001) Lujingzhongzi 314 (second instance); see Wang (ed.), *Abstracts and Comments on Marine Insurance Case of China*, Vol.1 (2003), pp.28–31(in Chinese).

[36] L. Fengning, "On Liability Risks Covered under Collision Liability Clause" (2009) 62 *Wuhan University Journal (Philosophy & Social Sciences)* 168 (in Chinese).

and art.170 of the CMC[37] further clarifies that an accident with no contact of ships is not a collision, but the ship collision provision will apply to it. It is therefore clear that collision in the CMC shall only refer to the physical collision (contact collision), and this definition is clear and unambiguous in Chinese law and practice; in such cases there is no need for standard hull clauses to define it again and the *contra proferentem* rule has no room to be applied.[38] It should be mentioned that in art.1 of the Judicial Interpretation of Ship Collision issued by the Supreme People's Court in 2008 it is clarified that the ship collision provided therein should mean ship collision as defined in art.165 of the CMC, excluding collision between inland river ships, while the provisions of the Judicial Interpretation shall be applied to the accident mentioned in art.170 of the CMC by analogy. By this interpretation, it seems that the opinion of the Supreme People's Court as to ship collision has been restored to the correct one. In comparison with the concept of ship collision, however, the wording of FFO in the collision liability clause is ambiguously large, so that a wide interpretation of FFO against the insurer will be applied to include any natural or artificial structures or objects other than ships, including ice and even coral reefs.[39]

In hull insurance disputes, the defence most frequently invoked by insurers seems to be exclusion of unseaworthiness. Before the assured discharges his burden of proof in producing evidence showing the claimed loss is caused by an event insured (e.g. peril of sea), the insurer is under no duty to prove the loss is caused by unseaworthiness. So even if the insurer's evidence is insufficient to prove that the cause of loss is unseaworthiness, the insurer is still not liable for the claim so long as the assured's claim is not appropriately substantiated.[40] This approach of Chinese law is similar to that adopted by the House of Lords in the *Popi M* case.[41] On the other hand, if the assured can prove a prima facie case of the event insured, the insurer shall not be exempted from liability unless the alleged exclusion, commonly unseaworthiness, is duly proved to be the cause of loss, and such a burden of proof generally cannot be easily discharged.[42]

Now we wish to make a detailed comment on an unusual hull insurance claim. In this case,[43] the plaintiff insured the ship with the defendant on domestic hull clauses on 25 March 1993 for 12 months. On 10 June 1993, when the ship was on a voyage from Chanzhou to Beihai, a fire was deliberately set on board the ship by the third officer of the ship and then the third officer jumped into the sea and

[37] It provides to the effect that in the case where a ship has caused damage to another ship even if no collision has actually occurred, the provision of ship collision (i.e. collision of ships) shall apply.

[38] Under Chinese law, the contra proferentem rule, i.e. an interpretation against the interests of clause drafter or provider (commonly insurer) shall not be applied unless the clause itself is ambiguous. See art.30 of the CIL and art.41 of the Chinese Contract Law.

[39] See H.D. Cai, "Ambiguous Insurance Clause leads to Unfavorable Interpretation against Insurer" (2002) 5 *China Ocean Shipping Monthly* 74 (in Chinese). In the arbitration case discussed in the article, the tribunal of the Chinese Maritime Arbitration Commission ruled that the stranding and contact with FFO can be co-existent in the same event insured; that is to say, a ship may incur liability for contact with FFO at the same time when she got stranded on the coral reef.

[40] See *MV Xinghai 888* hull insurance dispute, cited in Wang (ed.), *Abstracts and Comments on Marine Insurance Case of China*, Vol.2 (2008), pp.40–41(in Chinese). See also *MV Hailing 2* hull insurance dispute, Case No.(2011) Hugaominsihaizhongzi 129 (in Chinese).

[41] *Rhesa Shipping Co SA v Edmunds (Popi M)* [1985] 1 Lloyd's Rep. 1 HL.

[42] See MV *Nanxia 9* hull insurance dispute appealed and final Case No.(2008) Hugaominsihaizhongzi 1 (in Chinese).

[43] *Hainan Yangpu Hengtong Shipping Co v PICC Haikou Branch*; see D.F. Zhang, "Henghai hull insurance dispute", J. Zhengjia (ed.), (1997) 1 *Maritime Trial* 41.

killed himself. The damage of the ship caused by the fire was RMB 5 million. The plaintiff claimed the damage against the defendant on the ground of the fire as an insured event, but the defendant rejected the claim. The plaintiff brought an action against the defendant at Haikou Maritime Court. The defendant argued that there was no master on board the ship and the first officer was appointed as the acting master at the commencement of the concerned voyage. Since the third officer had conflicts with the first officer, the appointment of the first officer as the acting master directly led to the third officer setting a fire to destroy the ship. Furthermore, the first officer also failed to organise the other crew members to effectively prevent the wrongdoing, i.e. the setting of the fire, of the third officer. Accordingly, the lack of the master and the appointment of the first officer as the acting master constitute the unseaworthiness of the ship and that unseaworthiness was the proximate loss of the claimed damage. Since the assured was aware of such unseaworthiness, the insurer should not be liable for the resulting damage. It was held by Haikou Maritime Court that the insurer shall be liable for the loss caused by the fire. The pertinent issue in this case is to decide whether or not the unseaworthiness claimed by the defendant is the proximate cause of the damage. The court took the view that the damage was proximately caused by the fire and there was no causal connection between the unseaworthiness of the ship and the arson of the third officer. Therefore, the defendant was held liable. The defendant lodged an appeal to the High People's Court of Hainan Province, alleging the unseaworthiness of the ship was the proximate cause of the ship damage. The court of the second instance held that the defendant failed to establish the causal connection between the damage and the unseaworthiness and thus upheld the judgment of the first instance court and dismissed the appeal. The key issue in this case is whether or not the unseaworthiness is the proximate cause of the damage. In the opinion of the Chinese judges, where several causes are involved in causing a particular loss, the proximate cause should be the cause that operates effectively or dominantly in causing the occurrence of the loss. The doctrine of proximate causation in insurance in English law[44] seems to be generally followed by Chinese courts in this case and other cargo insurance cases as well.[45] From the fact of this case, the arson of the third officer has legal causal connection with the damage of the ship. Under the insurance clauses in this case, the insurer shall be liable for the damage caused by the fire, which should include the fire resulting from the arson of a third party. In this case, there is no effective causal connection between the arson of the third officer and the lack of the qualified master or the unseaworthiness due to the lack of the master. Therefore, the insurer shall be liable for the damage of the ship which was proximately caused by the fire rather than the unseaworthiness of the ship.

[44] For the detail of the doctrine of proximate cause in English law, see H. Bennett, "Causation in the Law of Marine Insurance" in D.R. Thomas (ed.), *The Modern Law of Marine Insurance* (London: LLP, 1996), p.173; and for the discussion of relevant English and American cases, see also J. Lowry and P. Rawlings, "Proximate Causation in Insurance Law" (2005) 68 *Modern Law Review* 310.

[45] For example, see Guangzhou Maritime Court Case No.(2005) Guanghaifachuzi 211; and Guangdong High People's Court Case No.Yuegaofaminsizhongzi 304 (in Chinese); and another cargo insurance case cited in Y. W. Li, "Proximate Causation—a Basic Principle in Insurance Claim Handling" (2003) 2 *Insurance Studies* 52 (in Chinese).

Summaries

In the above, the authors have conducted some in-depth discussions on important aspects of hull insurance law in China: specifically, insurable interest, good faith, subrogation and abandonment and the controversial issues in standard hull clauses of China.

It can be seen that, in China, hull insurance is subject to provisions of both the CMC and, in the absence of the provisions in the the CMC, the CIL, as well as standard insurance clauses. The CMC has transplanted a few important concepts from the English law in the area of marine insurance, such as the assured's duty of disclosure, subrogation and abandonment, while on the other hand the provisions of the CIL have a tradition of civil law. As a whole, the Chinese hull insurance law can be properly described as a combination of both English law concepts and the civil law tradition. So far as the relevant provisions in the CMC and CIL are concerned, the former is generally more favourable to the insurer while the latter is formulated to be more assured-friendly. However, it is easy for such a combination incur conflicts and controversies and it has been suggested that reform is needed to unify the marine and non-marine duty of disclosure regime into a single one.[46] It would be very hard to realise such a proposal in both legal provisions and judicial practice.

Under the present circumstances, even if there are some similarities between the Chinese hull insurance law and its English counterpart, caution must be taken to avoid the misunderstanding that Chinese courts would interpret relevant concepts in line with or following English doctrines and practices, let alone where the CMC keeps silence, either deliberately or inadvertently.[47] A number of provisions in the CIL that are strange to English law, the insurer's duty to explain being a typical one, will be applied to hull insurance as required by the literal and also simplistic wording of art.184 of the CIL. Against the background of the Chinese civil law system in its basic formation stage, we would suggest that Chinese hull insurance law is now taking a freestanding approach, although it has still been modelled on its English counterparts to some extent. However, in Chinese hull insurance law, there are still some loopholes and ambiguities that remain to be resolved by either legal provisions or judicial interpretations and judicial practices, and the law itself is thereby gradually evolving, We shall keep it within our sight so that it can be more properly developed and understood.

[46] See J. Zhen, "Insured's Duty of Disclosure and Test of Materiality in Marine and Non-marine Insurance Laws in China" [2006] J.B.L. 681, 704.

[47] If the drafters of the CMC think that some provisions are common to both marine and non-marine insurance so they are omitted from the CMC deliberately, it would of course be proper to apply such provisions in the CIL to marine or hull insurance. On the other hand, if some provisions should have been included in the CMC considering the special nature of marine or hull insurance, but owing to inadvertence or omission of the drafters they are omitted, the application of corresponding provisions in the CIL in full force and effect may be inappropriate.

Dual Class Shares around the Top Global Financial Centres

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Class rights; Hong Kong; Japan; Listing Rules; Shares; Singapore; Stock exchanges; United States; Voting rights

Abstract

Dual class shares (DCS) offer additional classes of shares that provide holders with greater voting rights. The article aims to investigate why leading financial centres have different attitudes towards DCS, with a focus on the recent reforms of their company law and listing rules with respect to DCS.

Introduction

Dual class shares (DCS) which could be created either through initial public offerings (IPOs) or recapitalisations, offer different classes of shares that confer distinct voting and control rights on the holder. The divergence provides insiders with a majority of voting rights, despite their smaller residual claims.[1] The popularity of DCS has been paralleled with a takeover wave since 1980 and an increasing number of technology companies entering the stock market.[2] Many US companies such as Google, Facebook, Groupon and LinkedIn, have favoured a DCS structure. However, not everywhere like the US welcomes such structure.[3]

DCS, despite having long existed, are back in the spotlight again owing to the listing of Alibaba on the New York Stock Exchange (NYSE), the largest IPO in history.[4] The company chose the NYSE over the Hong Kong Stock Exchange (HKEx) and the London Stock Exchange (LSE) as the latter two prohibit the listing of companies that employ "differential voting structures", namely DCS, while such a structure is permitted in the US. The request by the company in its IPO

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1 The dual class structure essentially creates a concentration of control that differs from concentrated ownership in general. See W. Ben-Amar and P. Andre, "Separation of Ownership from Control and Acquiring Firm Performance: The Case of Family Ownership in Canada" (2006) 33 *Journal of Business Finance & Accounting* 517.

2 G. Jarrell and A. Poulsen, "Dual-Class Recapitalisation as Antitakeover Mechanisms" (1988) 20 *Journal of Financial Economics* 129; and K. Rydqvist, "Dual-Class Shares: A Review" (1992) 8 *Oxford Review of Economic Policy* 45, 48.

3 HKEx, "Concept Paper: Weighted Voting Rights" (August 2014), p.40, *http://www.hkex.com.hk/eng/newsconsul/mktconsul/Documents/cp2014082.pdf* [Accessed 13 December 2016]. Basically speaking, there are three types of approaches to DCS around the world. The first category is jurisdictions which permit such a regime in both their corporate law and listing rules (e.g. the US, Canada and Sweden). The second category allows company to have DCS but having restrictions on listed companies (e.g. Hong Kong, UK and Australia). The third one is that both corporate law and listing rules prohibit a DCS structure (e.g. Germany, Spain and Mainland China).

4 On 19 September 2014, Alibaba, the largest Chinese e-commerce company, completed the largest IPO on the NYSE, raising US$25 billion and surpassing the 2010 offering from the Agricultural Bank of China. See N. Bullock et al, "Alibaba Closes at $93.89 in NYSE Debut" (20 September 2014), Financial Times, *http://www.ft.com/cms/s/0/8150f416-4002-11e4-a381-00144feabdc0.html#slide0* [Accessed 13 December 2016].

application for the granting of an exemption from the one share, one vote principle has brought the debate over whether the bourses should relax their listing standards to allow certain listed companies to adopt DCS.

The article aims to find out why the major jurisdictions particularly those leading financial centres, have different views on DCS and how divergent they are. The target is on the top five global financial centres, namely New York, London, Hong Kong, Singapore and Tokyo,[5] partly because of their significance to the world economy, partly because of the close association between financial centres and stock exchanges.[6] The article is structured as follows. After introduction, the second section will discuss the controversies over DCS from theoretical and empirical perspectives. The third section will investigate the attitudes of the five global financial centres towards DCS respectively, with a focus on the recent reforms of their company law and listing rules with respect to DCS. The fourth section concludes by discussing the implication for other jurisdictions.

Controversies over dual class shares—theoretical and evidential analysis

Lawyers and economists have divided opinions on DCS. In theory, DCS have been long criticised for violating the one share, one vote principle and destroying shareholder democracy.[7] One share, one vote is frequently described as a "legal consequence" of shareholder primacy, and a bedrock principle of corporate governance.[8] The rationale for one share, one vote is that shareholders, as residual claimants, have the strongest interest in maximising firm value and should therefore have equal voting rights.[9] In contrast, the disjunction between economic interest and voting power resulting from deviations from one share, one vote would make blockholders more prone to pursue value-maximising actions. In the view of Easterbrook and Fischel:

[5] Z/Yen Group, "Global Financial Centres Index 17" (March 2015), p.4, *http://www.longfinance.net/images/GFCI17_23March2015.pdf* [Accessed 13 December 2016]. In the light of market capitalisation by June 2015, the NYSE ranked as the No.1 largest stock exchange in the world, followed by Nasdaq (2nd), TSE (4th), LSE (5th), HKEx (7th) and SGX (21st). Data from World Federation of Exchanges, Monthly report as of 30 June 2015, *http://www.world-exchanges.org/statistics/monthly-query-tool* [Accessed 26 July 2015].

[6] Cassis states that stock exchanges set the pulse of financial centres. See Y. Cassis, *Capitals of Capital: The Rise and Fall of International Financial Centres 1780–2009*, 2nd edn (Cambridge: Cambridge University Press, 2006), p.6. The Top 10 financial centres in the world, according to the Global Financial Centre Index, all have stock exchange headquarters. Stock exchanges certainly contribute to financial centres in tangible (employment, infrastructure) and intangible ways (image, brand, reputation). See D. WZójcik, "Revolution in the Stock Exchange Industry: Two-sided Platforms, Battle for Liquidity, and Financial Centres" (2010), p.2, SSRN, *http://ssrn.com/abstract=1653827* [Accessed 13 December 2016].

[7] S. Grossman and O. Hart, "One Share-One Vote and the Market for Corporate Control" (1988) 20 *Journal of Financial Economics* 175; M. Harris and A. Raviv, "Corporate Governance: Voting Rights and Majority Rules" (1988) 20 *Journal of Financial Economics* 203; M. Harris and A. Raviv, "The Design of Securities" (1989) 24 *Journal of Financial Economics* 255. The three articles support the optimality of the one share, one vote rule and argue that multiple classes of shares are not socially optimal.

[8] F.H. Easterbrook and D. Fischel, *The Economic Structure of Corporate Law* (Cambridge, MA: Harvard University Press 1991), p.73 ("Votes follow the residual interest in the firm, and unless each element of the residual interest carries an equal voting right, there will be a needless agency cost of management"); and C. Dunlavy, "Social Conceptions of the Corporation: Insights from the History of Shareholder Voting Rights" (2006) 63 *Washington and Lee Law Review* 1347, 1367. However, Hayden and Bodle argue that the assumption of shareholder homogeneity is false as corporate democracies tend to define the requisite institutional interest too narrowly and thus restrict the right to vote to shareholders alone. See G. Hayden and M. Bodle, "One Share, One Vote and the False Promise of Shareholders Homogeneity" (2008) 30 *Cardozo Law Review* 445.

[9] H. Manne "Some Theoretical Aspects of Share Voting: An Essay in Honor of Adolf A. Berle" (1964) 64 *Columbia Law Review* 1427; F. Easterbrook and D. Fischel, "Voting in Corporate Law" (1983) 26 *Journal of Law and Economics* 395.

> "Those with disproportionate voting power will not receive shares of the residual gains or losses from new endeavors and arrangements commensurate with their control; as a result, they will not make optimal decisions."[10]

However, theory also recognises that one share, one vote comes with costs as it may deter entrepreneurs from going public to avoid the risk of the control and impair blockholders' ability to monitor management.[11]

The benefits and costs of DCS are summarised in the Canadian Coalition for Good Governance (CCGG) publication on dual class share policy.[12] On the one hand, DCS structures allow managers to concentrate on the sustainable success and profitability of the company, despite fluctuations in quarterly results.[13] Without worry about dismissal, managers will have less incentive to manage earnings at the expense of long-term value. In addition, they could also effectively reduce the likelihood that management is displaced in a hostile takeover so as to protect DCS companies from opportunistic acquirers.[14]

On the other hand, a discount to investor shares with inferior voting rights in a DCS structure may result in the extraction of private benefits and management entrenchment.[15] With few constraints placed upon them, managers holding superior class stock can entrench themselves into the operations of the company, regardless of their abilities and performance. However, it is unclear as to whether those risks actually lead to a negative impact on company performance.

There is extensive empirical evidence documenting the adoption and effects of DCS. But their findings are contradictory owing to the differing approaches taken to analyse the impacts of DCS.[16] Some studies affirm the hypothesis that DCS structures allow the extraction of private benefits and increase agency costs and financial risks to non-controlling shareholders.[17] They observe that DCS structures tend to underperform single-class structures, reflecting in companies with stronger

[10] Easterbrook and Fischel, *The Economic Structure of Corporate Law* (1991), p.73.

[11] M. Burkart and S. Lee, "One Share-One Vote: The Theory" (2008) 12 *Review of Finance* 1, 40–41.

[12] See the CCGG Publication on Dual Class Share Policy (September 2013), *http://admin.yourwebdepartment.com/site/ccgg/assets/pdf/Dual_Class_Share_Policy.pdf* [Accessed 13 December 2016].

[13] H. DeAngelo and L. DeAngelo, "Managerial Ownership of Voting Rights: A Study of Public Corporations with Dual Classes of Common Stock" (1985) 14 *Journal of Financial Economics* 33; and V. Dimitrov and P. Jain, "Recapitalization of One Class of Common Stock into Dual Class: Growth and Long-run Stock Returns" (2006) 12 *Journal of Corporate Finance* 342.

[14] G. Jarrell and A. Poulsen, "Dual-class Recapitalizations as Antitakeover Mechanisms: The Recent Evidence" (1998) 20 *Journal of Financial Economics* 129; and V.T. Nguyen and L. Xu, "The Impact of Dual Class Structure on Earnings Management Activities" (2010) 37 *Journal of Business Finance and Accountings* 456, 457.

[15] R. Ruback, "Coercive Dual-Class Exchange Offers" (1988) 20 *Journal of Financial Economics* 153; P. Gompers et al., "Extreme Governance: An Analysis of Dual-Class Firms in the United States" (2010) 23 *Review of Financial Studies* 1051.

[16] Some studies compare different companies with and without DCS for the conclusion that DCS structures have a negative effect on performance. But this is disagreed with by studies looking at the performance of listed companies in the period immediately following their IPOs, studies of companies that have unified a DCS structure, or studies of existing listed companies moving to a DCS structure. See HKEx, "Concept Paper: Weighted Voting Rights" (August 2014), IV, p.10, *http://www.hkex.com.hk/eng/newsconsul/mktconsul/Documents/cp2014082.pdf* [Accessed 13 December 2016].

[17] R. Masulis et al., "Agency Problems at Dual-Class Companies" (2009) 64 *Journal of Finance* 1697 (arguing that management are likely to exercise private benefits at the expense of outside shareholders in DCS companies); see also L. Bebchuk et al., "Stock Pyramids, Cross Ownership, and Dual Class Equity: The Mechanisms and Agency Costs of Separating Control from Cash Flow Rights" in R. Morck (ed.), *Concentrated Corporate Ownership* (Chicago: University of Chicago Press, 2000), pp.295–296 (arguing that cash flow rights or equity ownership of the controlling shareholder declines, the agency costs to non- controlling shareholders tend to rise at an alarming rate).

shareholder rights having higher firm value, higher profits, higher sales growth and lower capital expenditures, and fewer corporate acquisitions.[18]

In contrast, another group of empirical studies, though inconclusive, obtain opposite results that companies going public with DCS outperform their counterparts in terms of stock returns and accounting performance.[19] In addition, there are also subtle positive effects offered by DCS in some ways. DCS may be desirable because they are most likely to encourage managerial investment in firm-specific human capital and higher tender offers when there are multiple bidders with private benefits competing for control.[20]

More recently, one stream of research views that DCS are temporary structures kept until when the company requires new capital for expansion and growth.[21] This explains why a reverse trend has been witnessed in continental Europe that an increasing number of companies unify their shares into a single class in a view to increasing firm's market value and reducing the cost of new equity financing.[22]

Despite the debates, DCS are likely to persist and succeed in some jurisdictions. There is some consensus that without the availability of DCS, founders and entrepreneurs would be reluctant to take their companies public owing to the fear of losing control. In the long run, it may lead to a curtailment in the growth of new and emerging companies.[23] Some proactivists even claim that there is no social need to constrain the choice of share structure because companies that choose DCS will only do so if the benefits outweigh the cost.[24] But more realists propose that the centre of debate should be shifted to how the governance of DCS companies

[18] Burgundy Asset Management Ltd, "Second Class Owners?" (September 1996), *http://www.burgundyasset.com/data/newsletter/1996_09_Second_Class_Owners.pdf* [Accessed 13 December 2016] (finding that a tendency for companies with DCS to underperform in Canada but the performance differential is small); P. Gompers et al., "Corporate Governance and Equity Prices" (2003) 118 *Quarterly Journal of Economics* 107 (arguing that investors that bought companies with strongest rights and sold companies having weakest rights would have earned abnormal returns of 8.5% per year).

[19] E. Bohmer et al., "The Effect of Consolidated Control on Firm Performance: the Case of Dual-class IPOs" in Mario Levis (ed.), *Empirical Issues in Raising Equity Capital* (Amsterdam: Elsevier, 1996), pp.95–124; V. Dimitrov and P. Jain, "Recapitalization of One Class of Common Stock into Dual-Class: Growth and Long-Run Stock Returns" (2006) 12 *Journal of Corporate Finance* 342.

[20] H. DeAngelo and L. DeAngelo, "Managerial Ownership of Voting Rights: A Study of Public Corporations with Dual Classes of Common Stock" (1985) 14 *Journal of Financial Economics* 33, 62. M. Burkart et al., "Why Higher Takeover Premia Protect Minority Shareholders" (1998) 106 *Journal of Political Economy* 172 (arguing that higher takeover premia induced by competition translate into higher ownership concentration and are thus benefical).

[21] D. Ashton, "Revisiting Dual-Class Stock" (1994) 68 *St. John's Law Review* 863, 871 (arguing that DCS don't constitute "a permanent alteration in a firm's ownership structure"). B. Amoako-Adu and B. Smith, "Dual Class Firms: Capitalization, Ownership Structure and Recapitalization Back into Single Class" (2001) 25 *Journal of Banking and Finance* 1083.

[22] For the examination of DCS unification in Europe, see A. Pajuste, "Determinants and Consequences of the Unification of Dual-Class Shares", European Central Bank Working Paper Series No.465 (2005); and B. Maury and A. Pajuste, "Private Benefits of Control and Dual-Class Share Unifications" (2011) 32 *Managerial and Decision Economics* 355. For the unification of shares in individual country, see I. Dittmann and N. Ulbricht, "Timing and Wealth Effects of German Dual Class Stock Unifications" (2007) 14 *European Financial Management* 163; and O. Ehrhardt et al., "Unification of Dual-Class Shares in Germany: Empirical Evidence on the Effects of Related Changes in Ownership Structure, Market Value, and Bid-Ask Spreads", Swiss Finance Institute Research Paper Series No.06-12 (2005). Both discuss the decisions of German DCS companies to consolidate their share structure from dual to single class. For other jurisdictions such as Brazil and the US, see G. Engler, "Why They Persist? An Analysis of Dual Class Structures and the Unification Process in the US and Brazil" (2014) 10 *Revista Direito GV* 23.

[23] T. Gry, "Dual Class Share Structures and Best Practices in Corporate Governance" (2005), p.2, Library of Parliament, Parliamentary Information and Research Service, *http://www.parl.gc.ca/content/lop/researchpublications/prb0526-e.pdf* [Accessed 13 December 2016]. See also D. Cipollone, "Risky Business: A Review of Dual Class Share Structure in Canada and a Proposal for Reform" (2012) 21 *Dalhousie Journal of Legal Studies* 62, 69.

[24] K. Rydqvist, "Dual-Class Shares: A Review" (1992) 8 *Oxford Review of Economic Policy* 45.

can be improved so as to minimise the added agency costs while still maintaining their inherent efficiencies and benefits.[25]

Divided stances of global financial centres

This section examines the regulatory treatment of DCS in the top five global financial centres which have developed markets for trading listed securities.

New York

In the US the principle of one share, one vote in that each shareholder is entitled to only one vote regardless of the number of shares owned has been long discarded as a default rule under Delaware's company law but companies can opt out from it.[26] The NYSE and NASDAQ permit companies with pre-existing DCS structures to list on their markets, but do not allow an issuer, once listed, to implement a DCS structure that would discriminate against the interests of existing shareholders.[27]

The unbundling of cash flow and voting rights in the US dates back to 1925 when a few leading companies such as Dodge Brothers issued non-voting common stocks.[28] In response to the resulting public outcry, in 1926 the NYSE disapproved an issue of non-voting common stock by releasing a statement that it would review the matter of voting control carefully.[29] After the statement, the NYSE prohibited the issuance of non-voting securities, although it did not formally announce the prohibition until 1940.[30] As to why the it opposed such voting rights, the NYSE Listed Company Manual states:

> "[C]onsistent with the Exchange's long-standing commitment to encourage high standards of corporate democracy, every listed company is expected to

[25] C.-K. Hoi and A. Robin, "Agency Conflicts, Controlling Owner Proximity, and Firm Value: An Analysis of Dual-Class Firms in the United States" (2010) 18 *Corporate Governance: An International Review* 124 (suggesting that dual-class companies must seek additional control mechanisms to curb agency costs though controller proximity is unrelated to firm value); Cipollone, "Risky Business" (2012) 21 *Dalhousie Journal of Legal Studies* 62, 91.

[26] Delaware General Corporation Law s.212(a) states: "Unless otherwise provided in the certificate of incorporation … each stockholder shall be entitled to 1 vote for each share of capital stock held by such stockholder." For a general discussion on the "one share, one vote" rule, see C. Rohrlich, "Corporate Voting: Majority Control" (1933) 7 *St. John's Law Review* 218 (noting the trend away from the strict rule of equal voting rights); E. Sneed, "The Stockholder May Vote as He Pleases: Theory and Fact" (1961) 22 *University of Pittsburgh Law Review* 23, 23–24 (noting that the policy of voting equality was comparatively short-lived); D. Ratner, "The Government of Business Corporations: Critical Reflections on the Rule of 'One Share, One Vote'" (1970) 56 *Cornell Law Review* 1, 3–11 (generally outlining the development of the one share, one vote rule).

[27] NYSE Listed Company Manual, r.313(A); and NASDAQ Stock Market r.5640.

[28] Dodge sold a total of US$130 million worth of bonds, preferred stock and non-voting common shares to the public. Dodge was controlled, however, by an investment banking firm, which had paid only US$2.25 million for its voting common stock.

[29] The NYSE released an announcement in January 1926: "Without at this time attempting to formulate a definite policy, attention should be drawn to the fact that in the future the [listing] committee, in considering applications for the listing of securities, will give careful thought to the matter of voting control." See J. Seligman, "Equal Protection in Shareholder Voting Right: The One Common Share, One Vote Controversy" (1986) 54 *George Washington Law Review* 687, 694–697.

[30] In May 1940, the NYSE formally announced an official rule entitled "Statement of Listing Requirements as to Preferred Stock Voting Rights" against such listings. See R. Jennings, "The Role of the States in Corporate Regulation and Investor Protection" (1958) 23 *Law and Contemporary Problems* 193, 228 (arguing that such statement provides standards of fairness to prevent inequitable arrangements in multi-securities structures); S. Robbins, "An Evaluation of the New York Stock Exchange Listing Policy on Voting", New York Stock Exchange Study (1978), p.183 (stating that this apparently was "the first formal published enunciation that the Exchange would refuse to list non-voting common stock").

follow certain practices aimed at maintaining appropriate standards of corporate responsibility, integrity and accountability to shareholders."[31]

While the NYSE showed restraint,[32] the other two national securities exchanges such as the American Stock Exchange (AMEX) and the National Association of Securities Dealers (NASD), with which the NYSE competed, had a similar but less rigorous prohibition respecting voting provisions for common stock.[33] As DCS became more common, a view expressed by Gilson emerged: instead of the banning of DCS, the focus became dual class recapitalisations where existing shareholders effectively coerced into giving up their voting rights.[34] This approach would allow companies to enjoy the benefits of DCS without the problem of coerced shareholders. This new approach led to the proposal of r.19C-4 by the SEC on 7 July 1988. Under the rule, the SEC prohibited self-regulatory organisations from listing and trading the stocks of any company that issued new shares carrying more than one vote per share, but it allowed companies to issue shares with less than one vote per share and permitted those with unequal voting rights to still be traded.[35]

In the view of Bainbridge, the SEC's stance to object the strict one share, one vote standard rested on the basic ground that the various theoretical arguments in favour of a flat prohibition were unpersuaded, and the side effects of DCS on shareholder wealth were unclear and inconclusive.[36] Although r.19C-4 is a useful starting point in determining which types of DCS require regulation, it is not a sound model for self-regulatory organisation (SRO) rule-making owing to its inconsistency with general corporate law principles and uncertainty as to the rule's effect on other types of corporate transactions.[37] Furthermore, there was a debate over whether the SEC had the legal authority to enforce such policies on self-regulating stock exchanges. On 12 June 1990, a three-judge panel of the US Court of Appeals for the District of Columbia Circuit unanimously ruled that the SEC had exceeded its statutory authority delegated by the Congress.[38]

[31] *New York Stock Exchanges Listed Company Manual* (1983) s.3 para.301. For a full discussion on this rule, see Seligman, "Equal Protection in Shareholder Voting Right" (1986) 54 *George Washington Law Review* 687.

[32] The NYSE allowed a few exceptions such as Ford Motor Company which was able to get around the prohibition by issuing a class with inferior voting rights rather than no voting rights. See J. Howell, "The Survival of the US Dual Class Share Structure" (2014) *Journal of Corporate Finance* 1, 5. But the DCS of the Ford Motor Company were opposed by some institutions and blockholders who attempted to eliminate the structure and move to one vote per share. See Ford Motor Company, 5 April 2007 Form DEF 14A, *http://yahoo.brand.edgar-online.com/Default.aspx?companyid=3404&formtypeID=148* [Accessed 13 December 2016].

[33] See American Stock Exchange, Company Guide (1983) §§101–117. AMEX did not implement a non-voting prohibition until 1972, and AMEX standards for listing corporate securities are similar to NYSE, but less rigorous. See Howell, "The Survival of the US Dual Class Share Structure" (2014) *Journal of Corporate Finance* 1, 5; Seligman "Equal Protection in Shareholder Voting Right" (1986) 54 *George Washington Law Review* 687, 691–692 (discussing AMEX and NASD's restrictions on common stock voting rights).

[34] R. Gilson, "Evaluating Dual Class Common Stock: The Relevance of Substitutes" (1987) 73 *Virginia Law Review* 807.

[35] The new listing standards created by r.19C-4 prohibited a covered exchange from listing or continuing to list the equity securities of an issuer that takes one of the prohibited actions. It likewise prohibited a covered securities association from authorising the equity securities of such an issuer for quotation and/or transaction reporting on an automated quotation system. The Inter-mountain and Spokane Stock Exchanges were the only national securities exchanges excluded from coverage. The NASD was the only securities association affected by the rule, just as the NASDAQ system was the only affected automated quotation system. Finally, only those issuers registered with the SEC pursuant to Exchange Act s.12, 15 USC §781 (1988), were covered by the rule. Exchange Act Release No.25891 (7 July 1988). See S. Bainbridge, "The Short Life and Resurrection of SEC Rule 19C-4" (1991) 69 *Washington University Law Review* 565, 566–567.

[36] Bainbridge, "The Short Life and Resurrection of SEC Rule 19C-4" (1991) 69 *Washington University Law Review* 565, 578.

[37] Bainbridge, "The Short Life and Resurrection of SEC Rule 19C-4" (1991) 69 *Washington University Law Review* 565, 628.

[38] *Business Roundtable v SEC* 905 F. 2d 406 (D.C. Cir. 1990).

Despite the court's rejection of the 19C-4 rule, the NASD and the AMEX joined the NYSE to implement 19C-4 by allowing companies to introduce inferior voting shares in IPOs but barring them from reducing existing shareholders' voting rights through actions such as

> "the adoption of time phased voting plans, the adoption of capped voting rights plans, the issuance of super voting stock or the issuance of stock with voting rights less than the per share voting rights of the existing common stock through an exchange offer".[39]

In spite of the regulatory efforts to develop a uniform policy on DCS in all the US markets, the adoption of DCS still receives criticism. For instance, in 2004 when Google went public with a DCS structure on NASDAQ,[40] the influential proxy adviser, Institutional Shareholder Services (ISS) ranked Google near the bottom of its corporate governance rankings, below any company in the S&P 500 stock index.[41]

Despite controversies, DCS remain a growing part of the US scene. In 2012, 79 out of 114 controlled companies in the S&P 1500 composite posed DCS with disproportionate voting shares.[42] Studies have shown that companies are more likely to adopt DCS, especially in the American context, in three scenarios: first, when the company operates in industries with a substantial increase in takeover activity; secondly, when management reputation has increased, because of good past performance or reputable new management; and thirdly, when the company drastically changes features, affecting its product market (e.g. relevant change in technology or entrance into a new market), requiring it to make decisions on risky long-term investment without guarantee of success in the short run.[43]

The consequences of having a DCS structure have been reported by many. Adams and Ferreira review a wide range of empirical studies, and conclude that evidence on the value of the control premium strongly corroborates the hypothesis that sizeable private benefits exist, and that controlling shareholders enjoy private benefits at the expense of non-controlling shareholders.[44] However, the risks of entrenchment and private benefits may be outweighed by positive consequences of DCS: for example, greater capital structure flexibility and long-term returns.[45] Furthermore, The US legal and institutional frameworks also help minimise the negative effects of DCS by the dominance of professional investors, and a

[39] Section 313.00 of the *NYSE Listed Company Manual*.

[40] Google's dual class IPO had class A shares (with one vote per share), which were sold to outsiders in the IPO; it also had class B shares (with 10 votes per share), which were retained by the founders, Larry Page and Sergey Brin, as well as other insiders. See Google's website, "2004 Founders' IPO Letter", *https://investor.google.com/corporate/2004/ipo-founders-letter.html* [Accessed 13 December 2016].

[41] K. Delaney and A. Grimes, "For Some Who Passed on Google Long Ago, Wistful Thinking", *Wall Street Journal*, 23 August 2004 (which quotes the ISS special counsel Patrick McGurn: "Because Google lacks the usual checks and balances provided at public companies by shareholder votes, holders must closely scrutinize the judgement of the company's top decision makers. Rank-and-file shareholders have no meaningful avenue for recourse—other than selling their low-vote shares, of course—if the company loses its way.").

[42] Investor Responsibility Research Centre Institute (IRRCI), "Controlled Companies in the Standard & Poor's 1500: A Ten Year Performance and Risk Review" (2012), *http://irrcinstitute.org/pdf/FINAL-Controlled-Company-ISS-Report.pdf* [Accessed 13 December 2016].

[43] T. Chemmanur and Y. Jiao, "Dual Class IPOs, Share Recapitalisaitons, and Unifications: A Theoretical Analysis", European Corporate Governance Institute (ECGI)—Finance Research Paper Series (2006), p.7.

[44] R. Adams and D.Ferreira, "One Share-One Vote: The Empirical Evidence" (2008) 12 *Review of Finance* 51, 79.

[45] S. Bauguess et al., "Large Shareholder Diversification, Corporate Risk Taking, and the Benefits of Changing to Differential Voting Rights" (2012) 36 *Journal of Banking & Finance* 1244.

disclosure-based regime by imposing much stricter disclosure standards and taking active enforcement actions against market abuse as well as a litigious culture.[46]

London

The concept of one share, one vote is also the default position under the UK Companies Act 2006, but subject to any provision of the company's articles.[47] The Premium Listing Principles set out in Listing Rule 7.2.1AR apply to every company with a premium listing of their equity shares.[48] Under Premium Listing Principle 5, a listed company must ensure that it treats all holders of the same class of premium listed shares equally in respect of the rights attaching to such listed equity shares except where holders are in a different position.

On 2 October 2012, the Financial Conduct Authority (FCA) launched a consultation (CP12/25) entitled "Enhancing the effectiveness of the Listing Regime", largely in response to market pressure to improve protection for minority shareholders in premium-listed issuers with controlling shareholders.[49] Following on from CP12/25, the paper (CP13/15) was published in November 2013 to propose to amend the way that the listing principles are applied to listed companies.[50] One year later, the FCA published the final rules (PS14/8) regarding the two consultations, which came into force on 16 May 2014 subject to some transitional provisions.[51]

As proposed in CP13/15, two additional Premium Listing Principles, representing a "basic norm of behaviour for any company wishing to raise capital in a public market", now apply to premium-listed issuers as follows.[52]

- Premium Listing Principle 3: all shares in a premium-listed share class must carry an equal number of votes on any shareholder vote; and
- Premium Listing Principle 4: the aggregate voting rights of different premium-listed share classes should be broadly proportionate to their relative interests in the company's equity (taking into account the commercial rationale for the differences in the rights and the extent of dispersion and relative liquidity of the classes).[53]

In PS14/8, the FCA clarifies that the purpose of the new principles is to prevent artificial structures involving multiple classes with different voting powers, which

[46] R.S. Yeung Chan and J. Kong Shan Ho, "Should Listed Companies be Allowed to Adopt Dual-Class Share Structure in Hong Kong?" (2014) 43 *Common Law World Review* 155, 174–179.

[47] UK Companies Act 2006 s.284.

[48] See the website of the Financial Conduct Authority (FCA), *https://fshandbook.info/FS/html/handbook/LR/7/2* [Accessed 13 December 2016].

[49] For the full text, see *https://www.fca.org.uk/your-fca/documents/consultation-papers/fsa-cp1225* [Accessed 13 December 2016].

[50] CP13/15 covers feedback to CP12/25, near-final rules based on the original proposal; consultation on the revised or new proposals as a result of feedback received, and the associated draft rules. See FSA, "CP13/15: Feedback on CP12/25: Enhancing the effectiveness of the Listing Regime and Further Consultation" (2013), *https://www.fca.org.uk/static/documents/consultation-papers/cp13-15.pdf* [Accessed 13 December 2016].

[51] FCA, "PS14/8: Response to CP13/15—Enhancing the effectiveness of the Listing Regime" (2015), *https://www.fca.org.uk/news/ps14-08-enhancing-the-effectiveness-of-the-listing-regime* [Accessed 13 December 2016].

[52] Linklaters, "Latest FCA Proposals: Enhancing the Effectiveness of the Listing Regime" (November 2013), p.16, *http://www.linklaters.com/.../A17407415_v0.0_Linklaters_Briefing_FCA_CP13_ 15.pdf* [Accessed 3 August 2015].

[53] FCA (2013), Appendix X of CP13/15, p.16.

are designed to allow a small group of shareholders to exercise control.[54] However, the FCA acknowledges that different share classes may also be used for other purposes, for example, closed-ended investment funds use them to meet the differing investment needs of investors. The new rules are believed to tighten the UK listing regime for premium listed companies and ensure the overarching framework of best corporate governance practices, although it remains to be seen how it will work in practice.[55]

After Alibaba was denied listing by Hong Kong on corporate structure concerns, a debate over whether the LSE changes listing rules to secure the high-profile listing has been brought up. Some market optimists criticise the LSE's inflexibility in corporate governance, which they believe may affect its ability to attract big IPOs, and argue that the UK Corporate Governance Code to which premium listed companies adhere through a "comply or explain" regime may provide the possibility for a DCS company to list in London.[56] However, both the FCA and institutional investors are opposed to a change in the rules and keep a firm stance on the principle of one share, one vote to protect shareholders' interests.[57]

Until now, DCS have been rare among British listed companies, though the UK has one of the most liberal regimes in this regard. What makes the UK different from the US in light of DCS: one is the superpower of institutional investors who strongly support the one vote per share rule[58]; the other is the breakthrough rule which is "a threat" to DCS.[59]

DCS are unpopular in the UK owing to market pressure and successful opposition from institutional investors.[60] The proportion of shares owned by institutional investors in the UK companies dramatically rose over the 1960s and 1970s simultaneously with the emergence of multiple class share structures.[61] The institutional investors, having a significant proportion of the shares in the UK market, have incentives to promote good governance by reducing the number of

[54] FCA (2015), PS14/8, paras 5.21 to 5.22, p.31.

[55] J. Healy et al., "FCA Listing Rule Changes Applicable to Premium Listed Companies" (8 May 2014, *Skadden, Arps, Slate, Meagher & Flom LLP*, *https://www.skadden.com/insights/fca-listing-rule-changes-applicable-premium-listed-companies* [Accessed 13 December 2016].

[56] For example, J. Lyons, "Alibaba vs Corporate Governance: Rules for Listing around the World" (7 November 2013), *http://www.growthbusiness.co.uk/growing-a-business/company-flotations/2430487/alibaba-vs-corporate-governance-rules-for-listing-around-the-world.thtml* [Accessed 13 December 2016].

[57] E. Yiu, "British Regulator Backs Hong Kong Stance on Alibaba IPO" (20 March 2014), *South China Morning Post*, *http://www.scmp.com/business/money/markets-investing/article/1452681/british-regulator-backs-hong-kong-stance-alibaba* [Accessed 13 December 2016]; see also letter from the Council of Institutional Investors (CII) in response to Alibaba listing requested LSE to resist any pressure to change the listing standards to deviate from the principle of one share, one vote. See CII, "CII Letter to the London Stock Exchange on One Share, One Vote" (27 March 2014), *http://www.cii.org/.../03_27_14_CII_letter_to_london_stock_exchange_one_share _one_vote.pdf* [Accessed 4 August 2015].

[58] W.-G. Ringe, "Deviations from Ownership-Control Proportionality—Economic Protectionism Revisited" in U. Bernitz and W.-G. Ringe (eds), *Company Law and Economic Protection* (Oxford: Oxford University Press, 2010), p.228.

[59] L. Bebchuk and O. Hart, "A Threat to Dual-Class Shares", *Financial Times*, 31 May 2002.

[60] K. Rydqvist, "Dual Class Shares: A Review" (1992) 8 *Oxford Review of Economic Policy* 45, 47; B. Cheffins, *Corporate Ownership and Control: British Business Transformed* (Oxford: Oxford University Press, 2008), p.32; P. Davies, "Institutional Investors in the United Kingdom" in D. Prentice and P. Holland (eds), *Contemporary Issues in Corporate Governance* (Oxford: Oxford University Press, 1993), pp.85–87.

[61] Ringe, "Deviations from Ownership-Control Proportionality" in *Company Law and Economic Protection* (2010), p.228; see also B. Cheffins, "Law, Economics and the UK's System of Corporate Governance: Lessons from History" (2001) 1 *Journal of Corporate Law Studies* 71, 82; A. Johnston, "Takeover Regulation: Historical and Theoretical Perspectives on the City Code" (2007) 66 *Cambridge Law Journal* 422, 426. Taxes imposed on corporate profits, taxation of managerial and investment income and inheritance taxes drive investors to permit ownership to separate from control. See S. Bank and B. Cheffins, "Corporate Ownership and Control in the UK: The Tax Dimension" (2007) 70 *Modern Law Review* 778.

multiple class shares or non-voting shares.[62] As a consequence, listed companies on the LSE rarely employ derivations from the one share, one vote rule until today.[63]

In addition, the breakthrough rule is another reason why DCS are disfavoured in the UK. The breakthrough rule was adopted in the Takeover Bids Directive[64] with a view to eliminating certain pre-bid defences to takeovers. This rule enables a bidder who has accumulated 75 per cent of equity to break through the company's existing voting arrangements and exercise control as if the one share, one vote principle is upheld. Therefore, many observers have seen the breakthrough rule as an attack on controlling owners in DCS companies.[65] Established DCS would be undone or at least lose much of their significance.

Hong Kong

As a former British colony, Hong Kong's corporate and financial regime is largely inherited from the British system.[66] As a result, Hong Kong's rules are very similar to those in the UK where DCS have been systematically discouraged. The Hong Kong Companies Ordinance (Cap. 622) allows a Hong Kong incorporated company to provide, in its articles, for the issue of multiple classes of shares with different voting rights.[67] However, such company is prohibited by the HKEx, regardless of pre- and post-listing, in order to provide fair and equal treatment to all shareholders.[68] The prohibition is set out in the Main Board Rule 8.11 (GEM Rule 11.25 for its junior bourse). The Listing Rule 8.11 uses the wording of the 1983 NYSE Listed Company Manual and states that the share capital of a new applicant must not include shares of which the proposed voting power does not bear a "reasonable relationship to the equity interest" of such shares.[69]

[62] B. Black and J. Coffee, "Hail Britannia? Institutional Investor Behavior Under Limited Regulation" (1994) 92 *Michigan Law Review* 1997, 2034; Cheffins, *Corporate Ownership and Control* (2008), p.31; and J. Armour and D. Skeel, "Who Writes the Rules for Hostile Takeovers, and Why?—The Peculiar Divergence of U.S. and U.K. Takeover Regulation" (2007) 95 *Georgetown Law Journal* 1727, 1736.

[63] Among the companies examined by the Shearman & Sterling Study, only 5% had multiple voting rights in place. There were no non-voting shares at all. See Shearman & Sterling LLP, "Proportionality between Ownership and Control in EU Listed Companies: Comparative Legal Study" (2007), p.12, *http://www.ecgi.org/osov/documents/study_report_en.pdf*. In another report by Shearman & Sterling LLP, BP was the only company featuring multiple voting rights in the sample of 66 listed companies. But its ordinary shares were about 99.7% of the total outstanding capital. See Shearman & Sterling LLP, "Report on the Proportionality Principle in the European Union" (2006), *http://ec.europa.eu/internal_market/company/docs/shareholders/study/final_report_en.pdf* [Both accessed 13 December 2016].

[64] Takeover Directive 2004/25 art.11.

[65] M. Faccio and L. Lang, "The Ultimate Ownership of Western European Corporations" (2002) 65 *Journal of Financial Economics* 365; and M. Bennedsen and K.M.Nielsen, "The Impact of a Break-Through Rule on European Firms" (2004) 17 *European Journal of Law and Economics* 259, 260.

[66] The Hong Kong law always follows the footsteps of the UK law. For example, the genesis of the current framework is the Hong Kong Companies Ordinance of 1865, which mirrored the English Companies Act of 1862. Likewise, the UK Companies Act 1908 was followed by the Hong Kong Companies Ordinance 1911. The Hong Kong Companies Ordinance (CO) was designated as Chapter (Cap.) 32 in 1933 and no significant legislative initiative in company law was introduced until 1984, which reflected the UK Companies Act 1948. See H. Yeung and F. Huang, "Law and Finance: What Matters? Hong Kong as a Test Case" (2012) 3 *Asian Journal of Law and Economics* 1, 9. Again, the Hong Kong Companies Ordinance 2014 codifies directors' duties under s.465, which is based on s.174 of the UK Companies Act 2006. See K. Shan Ho, "Codification of Directors' Duty of Care and Skill in Hong Kong: A Welcome Clarification of the Law", Working Paper (June 2015), SSRN, *http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2618143* [Accessed 13 December 2016].

[67] Companies Ordinance (Cap. 622), s.588(4) and the Companies (Model Articles) Notice s.50(4).

[68] Fair and equal treatment to all shareholders is a fundamental principle of Hong Kong's Listing Rules. Main Board r.2.03(4) (GEM Rule 2.06(4)) provides that: "The Listing Rules reflect currently acceptable standards in the market place and are designed to ensure that investors have and can maintain confidence in the market and in particular that: … All holders of listed securities are treated fairly and equally."

[69] *NYSE Listed Company Manual* §3 (1983) r.313.00(D), and the HKEx Main Board r.8.11 provides that "the share capital of a new applicant must not include shares of which the proposed voting power does not bear a reasonable

The term "voting powers" in the Listing Rule is interpreted to be intended to restrict all DCS structures, including those that give enhanced or exclusive director election rights, and those that achieve the same effect by embedding such rights in the company's articles rather than by creating two classes of shares.[70] The Rule entitles the HKEx to approve the listing of DCS companies on a case-by-case basis in exceptional circumstances[71]; however, none of the DCS companies has been admitted by the HKEx under such exception.[72]

Listing Rule 8.11 has remained unaltered for more than two decades since its introduction for the sake of market integrity.[73] However, the HKEx has been recently under pressure to change r.8.11 in the wake of the rejection of Alibaba's listing plan which caused the loss of US$300 million in anticipated advisory fees for Hong Kong's financial community and consequently the harm on its trading volumes and prestige.[74] In order to attract Chinese technology companies, the 108-page Concept Paper was published by the HKEx on 29 August 2014 to seek public views about DCS.[75] The Concept Paper is intended to evaluate the debate on whether DCS companies should be allowed to list. If there were enough support, this would be followed by a formal public consultation on changes to local stock market regulations. The Concept Paper considered the principles of investor protection, the current regulatory framework, the competitiveness of Hong Kong as one of the world's top listing venues as well as other jurisdictional practices on DCS.

Having reviewed all the responses to the Concept Paper,[76] the HKEx published its conclusions on 19 June 2015, stating that there is support for a public consultation on proposed changes to its listing rules and the acceptability of DCS.[77] In its conclusions, the HKEx noted that a majority of respondents had expressed support for the use of DCS in some circumstances, and expressed its belief that there are measures to put in place to mitigate the potential risks to investors posed by DCS. The draft proposal included a range of measures designed to offer extra

relationship to the equity interest of such shares when fully paid ('B Shares'). The Exchange will not be prepared to list any new B Shares issued by a listed issuer nor to allow any new B Shares to be issued by a listed issuer (whether or not listing for such shares is to be sought on the Exchange or any other stock exchange except

(1) in exceptional circumstances agreed with the Exchange; or
(2) in the case of those listed companies which already have B Shares in issue, in respect of further issues of B Shares identical in all respects with those B Shares by way of scrip dividend or capitalisation issue, provided that the total number of B Shares in issue remains substantially in the same proportion to the total number of other voting shares in issue as before such further issue."

[70] HKEx, "Concept Paper" (2014), para.82.

[71] See the HKEx Main Board r.8.11 (GEM r.11.25) for the exceptional circumstance.

[72] Charltons Solicitors, "*Hong Kong Stock Exchange Publishes Concept Paper on Weighted Voting Rights!*, Newsletter Issue 259 (29 September 2014), *http://www.charltonslaw.com/hong-kong-law/hong-kong-stock-exchange-publishes-concept-paper-on-weighted-voting-rights* [Accessed 13 December 2016].

[73] Listing Rule 8.11 was introduced in 1989 in response to a stock market turmoil in March 1987, which was triggered by announcements of three companies with intention to offer classes of ordinary shares with disproportionate voting rights (described as "B" shares) via a bonus issue.

[74] F. Huang, "New York vs. Hong Kong—A Burst of Regulatory Competition: The Listing of Alibaba", University of Leicester School of Law Research Paper No.15-22 (2015), available at *https://ssrn.com/abstract=2630060* [Accessed 5 January 2017].

[75] HKEx, "Concept Paper" (2014).

[76] The responses were received from listed companies, HKEx staffs, professional bodies, market practitioners, institutional investors and retail investors. See the HKEx's website, "Responses to the Concept Paper", *https://www.hkex.com.hk/eng/newsconsul/mktconsul/responses/cp2014082r.htm* [Accessed 13 December 2016].

[77] For the full text of conclusions, see HKEx, "Consultation Conclusions: To Concept Paper on Weighted Voting Rights" (2015), *https://www.hkex.com.hk/eng/newsconsul/mktconsul/Documents/cp2014082cc.pdf* [Accessed 13 December 2016].

protection for shareholders, such as restricting the use of DCS to companies of a certain size.

However, the draft proposal to change listing rules was unanimously opposed by the Securities and Futures Commission (SFC) on the ground that the current proposal did not address how the Exchange's proposed conditions and safeguards pertaining to the structures could be monitored and what actions could be taken by regulators or public shareholders if they were not complied with.[78] It also criticised the regulators' subjective judgment on the eligibility criteria for DCS companies as it would give rise to regulatory uncertainty and could result in inconsistent and unfair decision-marking. Although HKEx's draft proposals offered a number of safeguards to prevent the abuse of its proposed DCS, the SFC questioned the adequacy of those safeguards in its statement. Lastly, the SFC concluded that Hong Kong's reputation would be harmed if DCS structures became commonplace, and emphasised that its regulatory function is to "uphold the core principles of fairness and transparency which underpin Hong Kong's reputation as an international financial centre".[79]

But the SFC's response was directed to primary listings and didn't mention the HKEx's proposals regarding secondary listings. Some commentators believe that the silence on secondary listing of DCS could be a good signal to potentially open the door for a DCS company which has already listed in a market with credible regulatory standards to list some shares in Hong Kong.[80] This could boost Hong Kong's equity markets by permitting secondary listings by US-listed companies with DCS structures and create a new way for companies to launch an IPO in Hong Kong even if their corporate structures would not meet the requirements for a primary listing. Following the SFC's release, HKEx announced that it would engage with the SFC to find out "the best way forward in light of the views of the SFC" as any rule change must require the approval of the SFC.[81]

A subsequent question has been raised: why the US can embrace DCS while Hong Kong cannot? Many researchers and practitioners have tried to find out some attributors that cultivate the DCS companies in the US but are not available in other countries. They conclude that legal and institutional frameworks particularly relevant to DCS include a deeper professional investor base, better protection of minority shareholders' rights and a litigious culture.[82] Unlike its US counterparts, Hong Kong stock markets are dominated by retail investors and family companies with concentrated ownership, so the Hong Kong authorities place a strong emphasis

[78] SFC, "SFC Statement on the SEHK's Draft Proposal on Weighted Voting Rights" (25 June 2015), *http://edistributionweb.sfc.hk/t/ViewEmail/j/C5CD004D12EE9F25/F672ACDCDBF32846942A2DF08F503B7C* [Accessed 13 December 2016].

[79] SFC, "SFC Statement on the SEHK's Draft Proposal on Weighted Voting Rights" (25 June 2015), *http://edistributionweb.sfc.hk/t/ViewEmail/j/C5CD004D12EE9F25/F672ACDCDBF32846942A2DF08F503B7C* [Accessed 13 December 2016].

[80] J. Noble, "Hong Kong Regulator Rejects Proposals for Voting Change" (25 June 2015), *Financial Times*, *http://www.ft.com/cms/s/0/12a62b6e-1b1f-11e5-8201-cbdb03d71480.html#axzz3h5fHZQoR*; see also A. Lee, "SFC Rejects HKEx Weighted Voting Rights Conclusions" (26 June 2015), IFLR, *http://www.iflr.com/Article/3465852/SFC-rejects-HKEx-weighted-voting-rights-conclusions.html* [Both accessed 13 December 2016].

[81] HKEx, "The Exchange's Response to the SFC's Statement in Relation to the Draft Proposal on Weighted Voting Rights", News Release (25 June 2015), *https://www.hkex.com.hk/eng/newsconsul/hkexnews/2015/150625news.htm* [Accessed 13 December 2016].

[82] Chan and Ho, "Should Listed Companies be Allowed to Adopt Dual-Class Share Structure in Hong Kong?" (2014) 43 *Common Law World Review* 155, 175.

on preventing abuses rather than curing these abuses.[83] This is also seen in the litigation system that distinguishes the two jurisdictions. Hong Kong takes a more ex ante approach to prevent litigation from occurring in the first place by imposing more stringent IPO requirements and public disclosure, while the US takes a more ex post approach by providing various mechanisms to investors and lawyers to purse lawsuits against abusers.[84] Owing to the different institutional conditions, the fear exists that the adoption of DCS would "easily lead to a lessening of confidence in Hong Kong as a major financial centre",[85] which is why Hong Kong opposes the indiscriminate issuance of shares.

Singapore

Traditionally, Singapore held firm against the dilution of the principle of proportionality.[86] The Singapore Stock Exchange (SGX) issued guidance in 2011 that Singapore did not permit a listing of DCS on the ground that they entrenched control.[87] But the listing of newspaper companies is an exception. The Singapore Newspaper and Printing Presses Act mandates the issue of separate classes of shares with different voting rights by Singapore's listed newspaper companies such as Singapore Press Holdings.[88] Every newspaper that publishes in Singapore must create two classes of shares: management shares and ordinary shares. Each management shareholder has 200 times the voting rights of an ordinary shareholder over any resolution relating to the appointment/dismissal of a director or any staff member of the newspaper company.[89] Management shares can only be owned by Singaporean citizens or corporations that have been approved by the Government, also permissions to hold management shares can be revoked by the Government.[90]

When the world's most widely supported football giant Manchester United gave up Singapore for a New York listing raising US$233 million in 2012, mainly owing to the denial of DCS by the SGX,[91] it raised the question as to whether the SGX missed attracting a global brand to list because of arcane corporate governance practices. Again, Alibaba went on to list in NYSE, achieving a spectacular success

[83] The proportion of retail investors in Hong Kong is estimated to be 36%. See Hong Kong Exchanges and Clearing Ltd, Retail Investors Survey 2011 (2012), *https://www.hkex.com.hk/eng/stat/research/Documents/RIS2011.pdf* [Accessed 13 December 2016]. In around 60% of listed Hong Kong companies, a family controls at least 10% of voting rights. See Richard Carney and Travers Child, "Changes to the Ownership and Control of East Asian Corporations between 1996 and 2008: the Primacy of Politics" (2013) 107 *Journal of Financial Economics* 494.

[84] King Fung Tsang, "Listing Destination of Chinese Companies: New York or Hong Kong?" (2010) 23 *Columbia Journal of Asian Law* 357.

[85] The Standing Committee on Company Law Reform, "The Third Interim Report of the Standing Committee on Company Law Reform: B Shares" (July 1987), para.12. An extract from that report (including the relevant paragraphs) is included in Appendix 1 of HKEx, "Concept Paper" (2014).

[86] Singapore Companies Act s.64.

[87] SGX, "The Capital Structure of Listed Companies in Singapore Regulators Column" (20 September 2011), Regulators Column, *http://www.mondovisione.com/news/the-capital-structure-of-listed-companies-in-singapore/* [Accessed 13 December 2016].

[88] Singapore Newspaper and Printing Presses Act (Cap. 206) s.10.

[89] Singapore Newspaper and Printing Presses Act s.10(1).

[90] Singapore's strict approach to press regulation, in particular public expressive conduct that reflects the ruling party's belief that the Government has the trust and respect of the population, fits Singapore better than the Western approach. See Singapore Parliament, "White Paper on Share Values" (1991), para.41; see also T. Li-ann, "Between Apology and Apogee, Autochthony: The 'Rule of Law' Beyond the Rules of Law in Singapore" (2012) *Singapore Journal of Legal Studies* 269; and P. Jen Yap, *Constitutional Dialogue in Common Law Asia* (Oxford: Oxford University Press, 2015), pp.118–119.

[91] D. Stanton and F. Lau, "Exclusive: Manchester United drops Asia IPO for U.S." (13 June 2012), *Reuters*, *http://www.reuters.com/article/2012/06/13/us-singapore-us-ipo-manchester-united-if-idUSBRE85C0MO20120613* [Accessed 13 December 2016].

on its debut in 2014, which left some wondering how many DCS companies the SGX could afford to sacrifice for the sake of its one share, one vote principle.[92] The debate about allowing DCS in Singapore was put on the agenda again in the light of the Government's process in revising the Companies Act to remove the one share, one vote restriction.[93]

In April 2011, the amendments to the Companies Act were proposed by the Steering Committee for the Review of the Companies Act (Steering Committee), which was established in 2007 to undertake a comprehensive review of the Companies Act.[94] The proposal suggested allowing companies to issue non-voting shares and shares carrying multiple votes if their articles allowed it and subject to certain safeguards.[95] In doing so, the Steering Committee explained that the rationale was that multiple-vote shares and non-voting shares would allow such companies greater flexibility in capital management. On the other hand, the contrary view is that treating all shareholders equally in respect of voting rights is fundamental for good corporate governance and minority shareholder holders in particular in the Asian context where family companies are common.[96]

The proposal by the Steering Committee was accepted by the Ministry of Finance (MOF) in October 2012.[97] The MOF believes that the implementation of the proposal will align Singaporean law with the main stream of developed countries, such as the US, which allow DCS.[98] In connection with the proposal, the MOF stipulates that certain safeguards are to be introduced.[99] In May and October 2013, MOF and the Accounting and Corporate Regulatory Authority (ACRA) had sought two rounds of public consultation on the draft Companies (Amendment) Bill 2013.[100]

[92] G. Eng Yeow, "'Dual-class Shares' May not be Apt for S'pore investors" (15 October 2014), Straits Times, *http://business.asiaone.com/news/dual-class-shares-may-not-be-apt-spore-investors* [Accessed 13 December 2016].

[93] D. Ho and S. Yuen Thio, "Time to rethink dual-class shares for public listed companies in Singapore", (1 October 2014), *Business Times*, *http://www.tsmplaw.com/news/Time%20to%20rethink%20dual-class%20shares%20for%20public%20listed%20companies%20in%20Singapore.pdf* [Accessed 4 August 2015].

[94] MOF, "Consultation Paper on the Report of the Steering Committee for Review of the Companies Act" (June 2011), *https://www.acra.gov.sg/uploadedFiles/Content/Publications/Public_Consultation/SCReportComplete28Jul.pdf* [Accessed 4 August 2015].

[95] MOF, "Consultation Paper on the Report of the Steering Committee for Review of the Companies Act" (June 2011), p.16, *https://www.acra.gov.sg/uploadedFiles/Content/Publications/Public_Consultation/SCReportComplete28Jul.pdf* [Accessed 4 August 2015]; "Recommendation 3.4 — Companies should be allowed to issue non-voting shares and shares with multiple votes; Recommendation 3.5 — Section 64 should be deleted".

[96] Drew & Napier LLC, "Amendments to the Companies Act: (1) Multiple-vote Shares and Non-voting Shares; (2) Electronic Register of Members" (27 November 2014), *http://www.drewnapier.com/Publications-Events/Legal-Updates/Amendments-to-the-Companies-Act-(1)-multiple-vote* [Accessed 14 December 2016].

[97] MOF and ACRA, "Review of the Singapore Companies Act — Ministry of Finance's Responses to the Report of the Steering Committee for Review of the Companies Act" (3 October 2012), paras 70–75, *http://www.mof.gov.sg/portals/0/Public%20Consultation/AnnexA_SC_RCA.pdf* [Accessed 4 August 2015].

[98] MOF and ACRA, "Review of the Singapore Companies Act" (3 October 2012), para.72, *http://www.mof.gov.sg/portals/0/Public%20Consultation/AnnexA_SC_RCA.pdf* [Accessed 4 August 2015].

[99] MOF and ACRA, "Review of the Singapore Companies Act" (3 October 2012), para.72, *http://www.mof.gov.sg/portals/0/Public%20Consultation/AnnexA_SC_RCA.pdf* [Accessed 4 August 2015]. Safeguards include: (1) shareholders must approve the issuance of shares with different voting rights via a special resolution; (2) information on the voting rights for each class of shares must accompany the notice of meeting at which a resolution is proposed to be passed; (3) companies must specify the rights for different classes of shares in their articles and clearly demarcate the different classes of shares so that shareholders know the rights attached to any particular class of shares; and (4) holders of non-voting shares will have equal voting rights on resolutions to wind up the company or on those that vary the rights of non- voting shares.

[100] MOF and ACRA, "Public Consultation on the Draft Companies (Amendment) Bill 2013" (2 May 2013), *https://www.acra.gov.sg/Publications/Public_Consultation/Public_Consultation_on_Draft_Companies_Amendment_Bill_2013/*; and "Public Consultation on Additional Proposed Amendments to the Companies Act" (23 October 2013), *https://www.acra.gov.sg/Publications/Public_Consultation/Public_Consultation_on_Additional_Proposed_Amendments_to_the_Companies_Act/* [Both accessed 14 December 2016].

The Companies (Amendment) Bill (No.25/2014) was passed by Parliament in October 2014.[101] The Amendment allows public companies to issue different classes of shares with either no voting rights or multiple voting rights with the removal of the one share, one vote restriction.[102]SGX and Monetary Authority of Singapore (MAS) are reviewing where DCS could extend to listed companies. SGX's existing policy of not listing issuers with DCS structures will continue to apply pending the conclusion of the review.[103] From the first quarter of 2016, public companies in Singapore can issue ordinary shares with different voting rights.[104] By allowing DCS, Singapore's attractiveness as a listing destination would be enhanced.

Although the Amendment is believed to boost local markets, some commentators suggest that regulators should liberalise the regulatory framework in a calibrated way, rather adopt the US model of DCS structures wholesale.[105] One suggestion is limiting DCS to certain companies, such as technology companies and mega-sized listings.[106] The former appears to be based on the recent trend of technology companies using DCS. For the latter, large IPOs will attract institutional investors, who are better equipped to evaluate company business and management. It has also been proposed that some restrictions and safeguards should be imposed on DCS, including the suspension of superior voting in certain trigger events such as insolvency or qualified accounts, and a three-year sunset provision for companies with existing structure.[107]

Tokyo

Historically almost all listings on Japanese stock exchanges had been of common shares. The only exception was Inpex Corporation, a privatised oil company, issuing shares with veto rights (so-called golden shares) owned by the Japanese Government in November 2004.[108] The provisions of the Commercial Code relating

[101] On 15 April 2015, ACRA announced that the legislative changes to the Companies Act will be effected in two phases. The first phase will be implemented on 1 July 2015. The second phase will commence in the first quarter of 2016. See ACRA, "Two-Phase Implementation of Companies (Amendment) Act 2014", *https://www.acra.gov.sg/Legislation/Two-Phase_Implementation_of_Companies_(Amendment)_Act_2014/* [Accessed 14 December 2016]. For the summary of the key changes of Companies Act, see Wai Yee Wan, "Recent developments in Singapore on company law and regulation: review of the Singapore Companies Act" (2014) 35 *Company Lawyer* 143.

[102] Companies Act (Amended) s.64 and 64A.

[103] ACRA, "Key Legislative Amendments to Be Effected in Phase 2", *https://www.acra.gov.sg/Legislation/Companies_Act_Reform/Key_legislative_amendments_to_be_effected_in_Phase_2/* [Accessed 14 December 2016].

[104] Drew & Napier LLC, "Amendments to the Companies Act: (1) Multiple-vote Shares and Non-voting Shares; (2) Electronic Register of Members" (27 November 2014), *http://www.drewnapier.com/Publications-Events/Legal-Updates/Amendments-to-the-Companies-Act-(1)-multiple-vote* ; and Lance Lim, "Recent Amendments to the Companies Act: Rethinking Dual-class Shares in Singapore — Caveat Emptor?" (1 January 2015), *http://www.lawgazette.com.sg/2015-01/1219.htm* [Both accessed 14 December 2016].

[105] "Dual-Class Shares could help Boost Local Market" (16 November 2015), *Straits Times*, *http://www.straitstimes.com/business/companies-markets/dual-class-shares-could-help-boost-local-market* [Accessed 14 December 2016].

[106] S. Yuen Thio, "Is Singapore Ready for Dual-Class Shares?" (15 October 2015), *Business Times*, *http://business.asiaone.com/news/singapore-ready-dual-class-shares* [Accessed 14 December 2016].

[107] M. Yuen Teen, "Say 'No' to Dual Class Shares" (27 November 2015), *Business Times*, *http://www.businesstimes.com.sg/opinion/say-no-to-dual-class-shares* [Accessed 14 December 2016].

[108] The term "golden share" arose in the 1980s when the British Government retained golden shares in privatised companies, and later the concept emerged in Russia and other European countries. They are typically held by the government in the process of the privatisation of a government company. They empower the government with decisive voting rights, thus to veto all other shares in a shareholder meeting. The "golden share" concept was introduced in the Japanese Companies Act 2005 as "preferred shares with veto rights" under art.108. For more details of the evolution of the golden share, see *http://www.mutantfrog.com/2011/06/13/the-tale-of-inpex-and-the-golden-share* [Accessed 14 December 2016].

to joint stock companies were replaced by the Japanese Companies Act 2005,[109] which incorporated certain fundamental changes with respect to classes of shares. Article 108 of the Companies Act 2005 allows a stock company to issue more than one types of share. A company issuing more than two types of shares under its articles of association is called a *shurui kabushiki hakkou kaishi* (company issuing class shares).

In response to the Companies Act 2005, the Advisory Group on Improvements to the Tokyo Stock Exchange (TSE) Listing System published its "Comprehensive Improvement Programme for Listing System 2007" in April 2007, discussing the requirements for listing of shares classified with respect to voting rights and the circumstances in which such shares should not be permitted.[110] The new listing rules were implemented in July 2008, consolidating a draft outline of a new listing system for classified shares,[111] and the "Listing System Improvement FY 2008".[112] The new listing rules relax regulations on the use of certain kinds of DCS in IPOs. But existing listed companies are still prevented from issuing a diverse assortment of class shares.

In the new rules, "shares classified with respect to voting rights" are defined as shares with no voting rights, shares with voting rights exceeding other classes of shares, and shares with voting rights fewer than the other classes of shares. The TSE will decide whether a company is qualified to issue two or more classes of shares having different voting rights on a case-by-case basis, taking into account any concern that the interests of existing shareholders might be impaired. The examination of an application for the issuance of such shares will involve a formal examination and a substantial examination. A formal examination, equivalent to listing requirements of common stocks, will check the applicant company's conformity to the numerical criteria defined in the "Criteria for Stock Listing Examination".[113] The substantive examination will determine whether the scheme of the relevant shares respects the interests of shareholders on the individual application basis.

Cyberdyne, known for the HAL robot suit, was the first company with DCS listed in TSE in March 2014.[114] Cyberdyne is authorised to issue two classes of shares—common stock and class B stock. Shareholders of both classes of stock

[109] The Japanese Companies Act was enacted in 2005 and experienced its first reform in 2012, which resulted in "The Outline for the Companies Act Reform". Based on the Outline, the amendments to the Companies Act (including several provisions concerning corporate governance) were passed by the Diet on 20 June 2014 and took into effect in May 2015. The English version of the full legal text of Japanese Companies Act 2005 is available at *http://www.wipo.int/wipolex/en/text.jsp?file_id=338223* [Accessed 14 December 2016]. For details of the Outline, see Goto Gen, "The Outline for the Companies Act Reform in Japan and its Implications" (2013) 35 *Journal of Japanese Law* 13. And for the latest amendment to the Companies Act, see Masamichi Sakamoto and Yohei Harima, "Companies Act Reform 2014: Can the New Amendment to the Companies Act of Japan Strengthen the Corporate Governance System of Japanese Listed Companies" (2014), *City Yuwa Partners*, *http://www.city-yuwa.com/english/publication/shared/PDF/JLG201415_cy_56-59.pdf* [Accessed 28 September 2015].

[110] TSE, "Comprehensive Improvement Programme for Listing System 2007" (24 April 2007), *http://www.jpx.co.jp/english/equities/improvements/general/tvdivq0000004iib-att/2007programjokyo-e.pdf* [Accessed 14 December 2016].

[111] The contents of the Outline are summarised by K. Yoshii, "A New Share-listing System in Japan" (July 2008), *https://www.amt-law.com/en/pdf/bulletins3_pdf/080821_1a.pdf* [Accessed 14 December 2016].

[112] TSE, "Listing System Improvement FY2008" (27 May 2008), *http://www.jpx.co.jp/english/equities/improvements/general/tvdivq0000004iib-att/080527.pdf* [Accessed 14 December 2016].

[113] An overview of the IPO on the TSE is available at the website of Japan Exchange Group (JPX), *http://www.jpx.co.jp/english/equities/listing-on-tse/new/basic/index.html* [Accessed 14 December 2016].

[114] Nikkei, "Cyberdyne to Debut on TSE Mothers Market in March" (20 February 2014), *http://asia.nikkei.com/Markets/Tokyo-Market/Cyberdyne-to-debut-on-TSE-Mothers-market-in-March* [Accessed 14 December 2016].

have the same rights with respect to dividends and distributions upon liquidation. But a class B shareholder has 10 times as many voting rights as a common shareholder given the same unit sizes. Class B shares were held only by Yoshiyuki Sankai, the president and CEO of the company, and two foundations for which he serves as a representative director.

After the IPO of Cyberdyne, the TSE again amended its listing rules on DCS in July 2014 in the course of the detailed examination of Cyberdyne's listing.[115] Two key points addressed in the 2014 amendment are (1) necessity and appropriateness for use of a DCS; and (2) a sunset clause.[116] The former requires that a DCS is necessary from the perspective of the common interests of shareholders to ensure that a certain person continues to be involved in the business, and the structure is appropriate to achieve such necessary purpose. Under this new rule, the TSE will examine the nature of shares of class stock and determine whether a DCS is necessary from the common interests of shareholders. The sunset clause prescribes that the weighted stock converts to common stock if the necessity of the DCS ceases to exit.

Despite some restrictions on DCS, some worry that opening the door to DCS may exaggerate agency problems by a group structure in listed companies, where public shareholders may be harmed by the activities of controlling shareholders or group-based management.[117] According to the TSE White Paper in 2015, among TSE-listed companies, 629 companies (18.4 per cent) have controlling shareholders.[118] Out of them, 61.8 per cent (11.4 per cent overall) have parent companies and 38.2 per cent (7.0 per cent overall) have a controlling shareholder other than a parent company. Insiders holding more voting rights relative to cash flow rights would extract more private benefits at the expense of outside shareholders, in particular in the context of Japan where a high percentage of a cross-shareholding structure between company and bank has severely destroyed transparency and information disclosure of capital market.[119]

Conclusion

The weighted voting rights structure is always controversial and is criticised by advocates of corporate governance as it is regarded as a breach of the principle of one share, one vote. However, the findings from the empirical studies on ownership disproportionality do not entirely agree with the theory. Enthusiasts believe that DCS allow entrepreneurs to bring their ideas to the public market at an early stage, and enable companies to plan for the long term.

[115] K.Toshima, "Cyberdyne's Dual-class IPO" (9 December 2014), *http://www.iflr1000.com/NewsAndAnalysis/Cyberdynes-dual-class-IPO/Index/1662* [Accessed 14 December 2016].

[116] TSE New Listing Guidebook, "Guidelines for Listing Examination II 6.(4)" (2015), *http://www.jpx.co.jp/english/equities/listing-on-tse/new/guide/tvdivq0000002g9b-att/bv22ga0000001ufs.pdf* [Accessed 14 December 2016].

[117] H. Kanda, "Regulation of Controlling Shareholders in Japan", Presentation at the EU Asia Corporate Governance Dialogue Conference 2015, *http://law.nus.edu.sg/clb/events/EACG_Dialogue_Conference2015/pdfs/hideki_rcsj_slides.pdf* [Accessed 14 December 2016]; and S. Chernenko et al., "Agency costs, Mispricing, and Ownership Structure", NBER Working Paper No.15910 (2010) (arguing that ownership structures including pyramids, business groups, DCS, are prone to agency problems.)

[118] TSE, "TSE-Listed Companies White Paper on Corporate Governance 2015", pp.8–9, *http://www.jpx.co.jp/equities/listing/cg/tvdivq0000008jb0-att/2015.pdf* [Accessed 14 December 2016].

[119] R. Masulis et al., "Agency Problems at Dual-Class Companies" (2009) 64 *Journal of Finance* 1697; and T.-K. Tan and X. Fang Fu, *Proceedings of the International Conference on Chinese Enterprise Research 2007* (World Scientific, 2008), p.169 (usually 60–70% of corporate stock is possessed by banks in Japan. Consequently, not only is the agency problem not easy to be discovered, but a lot of information cannot be disclosed.).

Around the top five global financial centres, most of them welcome or have changed their rules to allow DCS. The permission of the use of DCS upon an IPO by New York which has the largest stock exchange in the world raises a difficult question for stock exchanges and financial authorities in other countries. Singapore and Tokyo followed in its footsteps to reform their listing framework and company law to grant such voting arrangement. On the other hand, both centres, in particular Tokyo, have also tried to prevent the misuse of DCS by examining the necessity and appropriateness of the structure. By contrast, London and Hong Kong stand firm on restrictions on such structure to protect investors from exploitation despite the long debates in an attempt to attract high-profile technology companies to list in the territory.

Researchers and practitioners have tried to find out why the attitudes towards DCS are diversified in different jurisdictions. There must be some reasons that DCS are permitted and work well so far in the US, yet such structures have been criticised elsewhere for insufficient investor protection. One possible explanation is the discrepancy in legal and institutional frameworks that allow listed companies to adopt a DCS structure in favour of selected shareholders. In contrast to the US, the powerful position of institutional investors and the break-through rule in the UK may deter the development of DCS. Similarly, a paternalistic approach by Hong Kong to prevent the exploitation of shareholders beforehand leads the authorities to choose shareholder fairness over profit. In a nutshell, the suitability and adaptability of DCS is largely path dependent on the pre-existing institutional frameworks of the exchange as well as the jurisdiction in concern.

One way or another, DCS provides plenty of material for argument between competition and shareholder protection. It also brings challenges to other jurisdictions whether to relax the ban on such shares, in pursuit of its push to become an appealing venue for emerging technology companies.

Global Systemically Important Banks (GSIBs): Operating Globally, Regulated Nationally?

Christian Hofmann*

Economic conditions; Financial regulation; International banks; International co-operation; Regulatory bodies; Risk management; Systemically important financial institutions

Abstract:

Financial centres around the globe are reforming their regimes of bank regulation to better contain risks from global systemically important banks (GSIBs). They show remarkable readiness to adjust their national rules to internationally accepted standards and co-operate with their foreign peers. However, without binding commitments to transnational solutions for bank failures host nations of GSIBs continue to see incentives to prioritise national interests This article proposes a model for transnational commitments under the lead role of the home nations of GSIBs.

Introduction

The recent global financial crisis taught regulators many lessons. Two of the most important ones are that financial institutions can be too big to fail and too big to rescue (a most dangerous combination) and that national regulatory approaches respond insufficiently to challenges created by cross-border operations of banks. The crisis has also revealed the limited willingness of national regulators to collaborate with their foreign peers, even within the EU.[1] One crisis and dozens of bailouts of banks (and sovereigns[2]) later, the situation is improving.

In the aftermath of the financial crisis, there has been a global wave of new regulation for the financial sector of unprecedented magnitude. The targets of such regulatory reforms are currently banks, and more specifically banks of systemic relevance. While crises have often triggered reforms, they predominantly take place at national levels without regard to global implications. The current reforms

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[1] R. Weber et al. "Addressing Systemic Risk: Financial Regulatory Design" (2014) 49 *Texas International Law Journal* 149, 166; C. Bradley, "Breaking Up is Hard to Do: The Interconnection Problem in Financial Markets and Financial Regulation, a European (Banking) Union Perspective" (2014) 49 *Texas International Law Journal* 271, 288.

[2] On the 2012 Greek debt restructuring, see C. Paulus, "The Interrelationship of Sovereign Debt and Distressed Banks: A European Perspective" (2014) 49 *Texas International Law Journal* 201, 209; C. Hofmann, "Sovereign-Debt Restructuring in Europe Under the New Model Collective Action Clauses" (2014) 49 *Texas International Law Journal* 385, 425–426; C. Hofmann, "Greek Debt Relief" (2017) 37 OJLS forthcoming, available at *https://academic.oup.com/ojls/article-abstract/doi/10.1093/ojls/gqw017/2669587/Greek-Debt-Relief* [Accessed 17 January 2017].

are different. Resulting from the recognition that the operations of systemically important banks require global solutions, the regulators in financial centres around the world have started serious efforts to converge their regulatory approaches and to co-operate in order to achieve more national stability by striving for global stability.

In addition to implementing shared principles of substantial law of bank regulation, regulators in all parts of the world are establishing procedural mechanisms for transnational collaboration in bank crises, driven by the Basel Committee on Bank Supervision (BCBS) and the Financial Stability Board (FSB).[3] The focus of assimilation of regulatory standards and international co-operation is on banks of systemic relevance at the global level, and reforms are driven by their home nations and those host jurisdictions that are highly exposed to their risks.

Such developments are essential. Improvements in terms of (national and ultimately global) financial stability and reduction of sovereign debt can only be achieved in two alternative ways. One alternative reduces the presence and importance of GSIBs as mighty global players. Trends towards national ringfencing against the risks stemming from GSIBs are visible in many jurisdictions, and as understandable as such trends seem especially from the perspective of (smaller) host states, they cause inefficiencies for global finance. In comparison, assimilation of regulatory standards and close co-operation among regulators promise to reduce the need for unilateral ringfencing.

This article analyses these approaches. It starts by describing some of the developments since the outbreak of the global financial crisis in 2008 that have shattered confidence in the traditional approaches to financial regulation and have led to important changes. This narrative is followed by an outline of the most urgent regulatory challenges in response to risks from global banking. The main part discusses the remarkable achievements in the convergence of standards of bank regulation around the globe and cross-border cooperation among regulators and supervisors. This part includes a discussion of the recently updated list of GSIBs, the alignment of principles of substantive law of bank regulation, consolidation of bank supervision, and reform of bank resolution. Imperfections of this new regime are pointed out and improvements suggested before final conlusions reached.

Financial regulation from a global perspective—developments and challenges

Even prior to the recent global financial crisis, financial regulation covered a mulitude of areas with strong foci on transactional fairness and microprudential regulation of banks and other financial institutions. The current developments in financial regulation do not indicate a regime change. The traditional approaches have not declined in importance. Regulation of financial transactions remains

[3] On the FSB "Policy Development and Coordination", *http://www.financialstabilityboard.org/what-we-do/policy-development/* [Accessed 14 December 2016]; Emilios Avgouleas, *Governance of Global Financial Markets* (Cambridge: Cambridge University Press, 2012), pp.207–209; K.P. Follak, "The Basel Committee and EU Banking Regulation in the Aftermath of the Credit Crisis" in M. Giovanoli and D. Devos (eds), *International Monetary and Financial Law: The Global Crisis* (Oxford: Oxford University Press, 2010), para.8.11.

important, and microprudential regulation of banks has intensified.[4] The remarkable development is that these traditional fields of financial regulation have been complemented by an additional core field of regulation that currently seems to enjoy the highest degree of attention. This is not to say that financial stability on multiple levels was not given serious attention before the global financial crisis. The establishment of the Financial Stability Forum (FSF) in 1999, for example, is a strong indicator that financial stability became a serious concern at least after the outbreak of the Asian financial crisis. It can, however, be said that it has never been in the limelight to the degree it currently is.[5] Macro-stability on the domestic, regional and global level has become a core objective of regulators and supervisors worldwide. The formerly prevailing view that macroeconomic policy is an integral part of monetary policy has been replaced by expansive mandates for regulators and supervisors to exercise their competences in the interest of macroprudential stability.[6]

Resulting from this strong regulatory focus on macroprudential stability, financial regulation is expanding into formerly unregulated fields. A recent example for this is the regulation of OTC transactions by EMIR and Dodd Frank. Self-regulatory areas have come under scrutiny, e.g. Libor after the revelations of severe manipulation by a number of banks. The widely unregulated credit default swaps will most likely be addressed in the near future,[7] and the ISDA regime raises the question of whether stronger regulation and public supervision can be considered dispensable.[8]

While financial regulation targets a wide range of providers of financial services and financial products, banks look back at the longest history of strict prudential regulation: the need for authorisation of the banking business and close prudential supervision of banks has been undisputed for over 100 years. There are two main reasons for this focus on banks. The protection of their customers, in particular the depositors, was and still is the main driving force behind strict and intrusive regulatory approaches. A second reason has gained momentum: ever since bank operations went from local to national and then global,[9] failures of banks have caused serious shocks in the financial world, affected the national, regional and sometimes the global economy and impacted on states and their governments. However, while the likelihood of bank failures has decreased owing to stricter

[4] On increased protection for financial consumers, see OECD, *Ninth Draft Summary Report on Effective Approaches to Support the Implementation of the G20 High-Level Principles on Financial Consumer Protection* (September 2013), *http://www.oecd.org/g20/topics/financial-sector-reform/G20EffectiveApproachesFCP.pdf* [Accessed 14 December 2016].

[5] E. Ferran and K. Alexander, "Can Soft Law Bodies be Effective? The Special Case of the European Systemic Risk Board" (2010) 35 E.L. Rev. 751, 752.

[6] M. Andenas and I. Chiu, *The Foundations and Future of Financial Regulation* (Abingdon: Routledge Chapman & Hall, 2014), pp.18–22; L. Garicano and R. Lastra, "Towards a New Architecture for Financial Stability: Seven Principles" (2010) 13 *Journal of International Economic Law* 597; Follak, "The Basel Committee and EU Banking Regulation in the Aftermath of the Credit Crisis" in *International Monetary and Financial Law* (2010), para.8.09; J. Armour et al., "Principles of Financial Regulation", (Oxford: Oxford University Press, 2016), p.14.

[7] IOSCO, "The Credit Default Swap Market" (June 2012), *https://www.iosco.org/library/pubdocs/pdf/IOSCOPD385.pdf* [Accessed 14 December 2016]; R. Squire, "A Market for End-of-the-World Insurance? Credit Default Swaps on US Government Debt" in F. Allen et al., *Is U.S. Government Debt Different?* (Philadelphia: FIC Press, 2012), p.69.

[8] D. Awrey, "The Limits of Private Ordering Within Modern Financial Markets" (2014–15) 34 *Review of Banking and Financial Law* 183.

[9] For the US see J. Gordon and W.-G. Ringe, "Bank Resolution in the European Banking Union: A Transatlantic Perspective on What it Would Take", University of Oxford Legal Research Paper Series, Paper No.18/2014 (August 2014), p.14.

regulatory requirements and closer supervisory monitoring, the effects have increased as a result of interconnected markets and interdependent banks and states.

The challenges to the regulation of global banking

Regulation, however, faces a serious challenge: while GSIBs operate globally, regulation is a national task, and whereas such national approaches are sufficient for banks with a local focus, the activities of GSIBs are difficult to monitor from a national perspective. National supervisors may find it difficult, if not impossible to keep track of their banks' global business. Yet, the shared practice is that home supervisors seek to monitor transactions world-wide, and in doing so they rely on the institutions to conform with their reporting obligations.

Under the current regime, it seems dangerous, and therefore potentially irrational (and yet, for practical reasons, unavoidable) to deal with GSIBs, in particular with those not headquartered in one of the largest economies. The unwritten rule of global finance states that SIBs will be bailed out by their home countries, and here the global financial crisis has confirmed what has always seemed obvious.[10] If a SIB grows too big, it cannot be bailed out by its home country, especially if the home country is one of the smaller economies of the world.[11] While external sources of financial help for sovereigns exist, their means are limited. A global financial crisis may require amounts of financial assistance well exceeding the amounts the IMF is mandated to grant, and concerted regional efforts like those that have led to the creation of the euro zone bailout facilities for sovereigns, i.e. the European Financial Stability Facility (EFSF) and European Stability Mechanism (ESM), are not universally available.[12] Resulting from this situation, the risks emanating from a SIB depend on two factors, the volume of assets and liabilities and interconnectedness of the SIB on the one hand and the capacity of the home country's economy to bail out the banks on the other.[13]

Cross-border effects of bank defaults were highlighted by the collapse of banks from Iceland in 2008. Iceland was criticised for insufficiently monitoring its financial sector[14] and for pursuing a strategy of pure national interest, deciding to bail out its banking sector only in part, leaving foreign depositors uncompensated. Both caused negative spillover effects in European countries where host state governments decided to compensate their national depositors.[15] Iceland's decision

[10] J. Westbrook, "SIFIs and States" (2014) 49 *Texas International Law Journal* 329, 331; on bailouts see A. Campbell and R. Lastra, "Revisiting the Lender of Last Resort" (2008–2009) 24 *Banking and Finance Law Review* 453, 454–457; P. Davies, "Resolution of Cross-border Groups" in M. Haentjens and B. Wessels (eds), *Research Handbook on Crisis Management in the Banking Sector* (Cheltenham: Edward Elgar Publishing Ltd, 2015), p.261 at p.264.

[11] Compare M. Schillig, "Bank Resolution Regimes in Europe—Part 1: Recovery and Resolution Planning, Early Intervention" (2013) 25 *European Business Law Review* 751, 756.

[12] On these financial facilities, see J.-V. Louis, "The No-Bailout Clause and Rescue Packages" (2010) 47 C.M.L. Rev. 971, 986; D. Zandstra, "The European Sovereign Debt Crisis and Its Evolving Resolution" (2011) 6 *Capital Markets Law Journal* 285, 288; S.M. Seyad, "A Legal Analysis of the European Financial Stability Mechanism" (2011) 26 *Journal of International Banking Law and Regulation* 421, 424–426; C. Hofmann, "A Legal Analysis of the Euro Zone Crisis" (2013) 18 *Fordham Journal of Corporate and Financial Law* 519, 525–530.

[13] G. Ferrarini and L. Chiarella, "Common Banking Supervision in the Eurozone: Strengths and Weaknesses", ECGI Law Working Paper No.223/2013 (August 2013), after fn.126.

[14] Compare Avgouleas, *Governance of Global Financial Markets* (2012), pp.209 and 247–248.

[15] Davies, "Resolution of Cross-border Groups" in *Research Handbook on Crisis Management in the Banking Sector* (2015), p.263; Westbrook, "SIFIs and States" (2014) 49 *Texas International Law Journal* 329, 337ff and 353; Andenas and Chiu, *The Foundations and Future of Financial Regulation* (2014), p.55; Avgouleas, *Governance of Global Financial Markets* (2012), p.248.

ignored the provisions of the EU Directive on deposit-guarantee schemes. Iceland is a member of the European Economic Area (EEA) and the relevant directive is applicable in EEA Member States.[16] This directive requires the home country schemes to cover losses of foreign depositors who have given money to branches abroad.[17]

Irish banks did not default on their obligations, but this was due to a comprehensive bailout made possible by European financial assistance to the Irish Government under the EFSF. Without this aid, a default would have seemed inevitable since the Irish budget comprised insufficient amounts to rescue the ailing financial sector. Finally, the banks in Cyprus defaulted on parts of their obligations, despite significant financial aid for Cyprus provided by the ESM.[18]

These experiences point to the unresolved complications caused by cross-border effects of insolvencies of internationally operating banks. Outside the EU/EEA, there is no legally binding regime that would require the home country deposit insurance scheme to cover the losses of foreign depositors who put their money in branches of the bank in host countries.

The first question that arises in this respect is whether the parent is liable for the group's global activities. The starting point is the distinction between branches and subsidiaries since only the latter possess separate legal personality while every commitment of the former is actually an obligation of the primary establishment.[19] Notwithstanding the distinction of branches and subsidiaries is the further issue whether the depositors in the host country are protected by the guarantees of deposit insurance schemes. While host country deposit insurance schemes usually provide coverage for deposits held by subsidiaries of foreign banks, the rules for branches are less general.

The US, arguably the largest exporter of financial risk stemming from GSIBs (based on the current list of GSIBs below), does not provide coverage for depositors in foreign US branches by its deposit insurance scheme. The Federal Deposit Insurance Company (FDIC) has declared that "deposits in foreign branches of U.S. banks … are not FDIC-insured".[20] In the EU/EEA, the opposite principle applies to branches of EU/EEA banks: the home country deposit guarantee scheme compensates the depositors in host countries. For branches of banks from countries outside the EU/EEA, the situation is less clear. The relevant EU directive leaves EU host countries two options: to rely on coverage by the home country deposit

[16] Directive 94/19 [1994] OJ 135/5, replaced by Directive 2014/49 [2014] OJ 173/149.

[17] Compare Westbrook, "SIFIs and States" (2014) 49 *Texas International Law Journal* 329, 337–341; Andenas and Chiu, *The Foundations and Future of Financial Regulation* (2014), p.55; Ferrarini and Chiarella, "Common Banking Supervision in the Eurozone: Strengths and Weaknesses", ECGI Law Working Paper No.223/2013 (August 2013), p.9. The EFTA Surveillance Authority ruled, however, in favour of Iceland: Case E-16/11 (2013) EFTA of 28 January 2013.

[18] For narratives about the crises in Europe, see M. Burda, "The European Debt Crisis: How Did We Get into this Mess? How Can We Get out of it?" in C.G. Paulus (ed.), *A Debt Restructuring Mechanism for Sovereigns* (London: Bloomsbury Publishing, 2014), p.21 at pp.24–28; A. Chiotellis, "Sovereign Debt Restructuring and the Internal Legal Framework: The Greek Experience" *A Debt Restructuring Mechanism for Sovereigns* (2014), p.99 at pp.100–102. On bank bailouts, see T. Tröger, "The Single Supervisory Mechanism—Panacea or Quack Banking Regulation?" (2014) 15 *European Business Organization Law Review* 449, 458. For the ESM, see fn.12.

[19] Defined by art.2(1)(10) of Directive 2014/49 [2014] OJ 173/149; W. Bossu and D. Chew, "'But we are Different!': 12 Common Weaknesses in Banking Laws, and What to Do about Them", IMF Working Paper WP/15/200 (September 2015) p.28, *https://www.imf.org/external/pubs/cat/longres.aspx?sk=43274.0* [Accessed 14 December 2016].

[20] "FDIC approves final rule on the definition of deposit at foreign branches of US banks to clarify that these deposits are not insured by the FDIC", Press Release (10 September 2013), *https://www.fdic.gov/news/news/press/2013/pr13009.html* [Accessed 29 December 2015] (applies even to deposits dually payable in the host country and the US).

guarantee scheme or to require membership in the national (i.e. host country) scheme.[21] Singapore probably reflects the most common approach outside the US and EU/EEA and requires every bank taking retail deposits to become a member of its insurance scheme,[22] while jurisdictions such as New Zealand without any deposit insurance apply no requirements to foreign banks.[23]

If host country depositors are referred to home country insurance schemes, their position is weak.[24] Some may have no claims against home country insurance schemes and be treated as unsecured general creditors. Others who hold claims against deposit guarantors depend on their enforceability in the home country. Situations such as the past experience with deposits made at foreign branches of Icelandic banks may reoccur, revealing the hazard that in situations of severe crisis politicians may prioritise national interests.

The second issue is that efforts to align bank resolution regimes have only recently begun. The discussion about the protection of bank creditors has traditionally focused on depositors. While certainly a very important aspect, it should not be forgotten that banks finance their transactions in various ways, e.g. by issuing commercial papers, leading to large exposures of non-equity investors.[25] Some jurisdictions give local creditors priority access to local assets over foreign creditors. In the case of liquidation, foreign creditors in host countries likely receive little or nothing if the banking group's assets are predominantly located in the home country which is often the case if the foreign operations are conducted via branches and these branches are not strictly ringfenced. The Lehman collapse of 2008 stirs up bad memories. The Lehman insolvency showed how interconnected subsidiaries and branches of globally operating financial institutions are, leading to the issue that, factually speaking, risks and liabilities cannot clearly be attributed to different entities in financial groups.[26]

Liquidations along jurisdiction lines seem therefore suboptimal, arguing strongly in favour of co-ordination among regulators, but such collaboration was missing in the insolvency of the Lehman Brothers financial services group. Lehman "repatriated" its global cash reserves to its US holding company at the end of a business day. When Lehman US filed for bankruptcy on 15 September 2008, the daily practice of sending cash to overseas subsidiaries ended, leaving them with assets of lower liquidity.[27]

Countries have responded to these cross-border issues by unilateral regulation. Ironically, the global trend to regulate banks more strictly in their home jurisdictions is coupled with harsher requirements for foreign banks in host countries. While

[21] Directive 2014/49 [2014] OJ 173/149 arts 14, 15.

[22] C. Hofmann, "Bank Regulation in Singapore" (2015) 1 J.F.R. 306, 321.

[23] On New Zealand, see the Treasury announcement, "Crown's Extended Retail Deposit Guarantee Scheme ended on 31 December 2011", *http://www.treasury.govt.nz/economy/guarantee/retail* [Accessed 14 December 2016].

[24] See M.H. Moskow, "Cross-Border Banking: Forces Driving Change and Resulting Regulatory Challenges" in G. Caprio, D.D. Evanoff and G.G. Kaufman (eds), *Cross-Border Banking: Regulatory Challenges* (Singapore: World Scientific Publishing Co Inc, 2006), p.3 at pp.6–8; E. Cerutti, G. Dell'Ariccia and M. Soledad Martínez Pería, "How Banks Go Abroad: Branches or Subsidiaries" (2007) 31 *Journal of Banking & Finance* 1669, 1670–1672.

[25] Gordon and Ringe, "Bank Resolution in the European Banking Union" (August 2014), p.15.

[26] Ferrarini and Chiarella, "Common Banking Supervision in the Eurozone" (August 2013), p.9.

[27] N. Lyngen and C. Simmons, "The Financial Stability Board: The New Face of International Financial Regulation" (2013) 54 *Harvard International Law Journal Online*, *http://www.harvardilj.org/wp-content/uploads/2013/08/Lyngen-Simmons-to-publish1.pdf* [Accessed 14 December 2016]; Davies, "Resolution of Cross-border Groups" in *Research Handbook on Crisis Management in the Banking Sector* (2015), p.264; Westbrook, "SIFIs and States" (2014) 49 *Texas International Law Journal* 329, 345.

stricter home country regulation should create more confidence in the soundness of foreign banks in host countries, many jurisdictions are showing stronger awareness for the systemic risks stemming from foreign banks, especially those that are systemically relevant to the host country. National ringfencing efforts have increased since the outbreak of the financial crisis; this trend may seem rational from the national perspective, but it is a negative development in global economic terms.[28] For banks and creditors alike, it is more beneficial to unite resolution efforts and treat groups of banks as single entities and to abstain from any attempts of foreign creditor discrimination.[29] But such transnational solutions require substantial regime changes. The objectives of recovery and restructuring efforts and resolution regimes must be internationally aligned. If national goals are prioritised, e.g. the protection of the domestic workforce, co-operation cannot function. Only the joint pursuit of minimisation of spillover costs in all affected countries will reduce negative externalities (see more detail below in subsection "Co-ordination among resolution authorities—general principles").[30]

Examples of unilateral national actions are the US reforms that subject foreign SIFIs (as determined by US regulators) to higher risk-weighted equity ratios and ringfencing requirements. Foreign SIFIs are required to establish holding companies in the US and are banned from certain high-risk activities, not only in the US, but globally.[31] This is the strictest form of asset pledge requirements that ensure that sufficient assets are located in the relevant jurisdiction and can be seized when the institution fails.[32] With such requirements, the US regulator attempts to shield the US market from extraterritorial crises of foreign institutions.

A further example is Singapore, with its powerful financial sector that welcomes the presence of foreign GSIBs in addition to its regionally important home banks.[33] Singapore has recently stepped up its regulatory requirements for foreign banks and changed its amicable approach to banks' preference for branches over incorporation in foreign markets. Whereas, generally speaking, regulatory differences of branches and subsidiaries are not overwhelming, the freedom of choice seems favourable to SIBs. Subsidiaries are often subject to capital and liquidity requirements, but branches are only obliged to meet minimum asset maintenance requirements.[34] These regulatory distinctions come in addition to general structural differences stemming from principles of company law such as legal independence and corporate responsibility of decision-makers in subsidiaries.[35]

[28] Westbrook, "SIFIs and States" (2014) 49 *Texas International Law Journal* 329, 346; Moskow, "*Cross-Border Banking*: Forces Driving Change and Resulting Regulatory Challenges" in Cross-Border Banking (2006), p.4; N. Le Pan, "Regulatory Challenges: The Road Ahead" in *Cross-Border Banking* (2006), p.29 at p.33.

[29] Compare Moskow, "*Cross-Border Banking*: Forces Driving Change and Resulting Regulatory Challenges" in Cross-Border Banking (2006), pp.6–8.

[30] On the entire paragraph R.J. Herring, "Conflicts between Home and Host Country Supervisors" in D.D. Evanoff, G.G. Kaufman and J.R. LaBrosse (eds), *International Financial Instability: Global Banking and National Regulations* (Singapore: World Scientific, 2007), p.201 at p.211.

[31] On the strict ringfencing rules for foreign banks in the US see Federal Register Vol.79, No.59 of 27 March 27 2014, p.17240; Federal Reserve System, "Press Release" (18 February 2014), *http://www.federalreserve.gov/newsevents/press/bcreg/20140218a.htm* [Accessed 14 December 2016]; Bradley, "Breaking Up Is Hard to Do" (2014) 49 *Texas International Law Journal* 271, 275.

[32] E. Hüpkes and D. Devos, "Cross-border Bank Resolution: A Reform Agenda" in *International Monetary and Financial Law* (2010), paras 17.09 to 17.13.

[33] Hofmann, "Bank Regulation in Singapore" (2015) 1 J.F.R. 306, 313.

[34] Bossu and Chew, "'But we are Different!'" (September 2015) pp.29–30, *https://www.imf.org/external/pubs/cat/longres.aspx?sk=43274.0* [Accessed 14 December 2016].

[35] Herring, "Conflicts between Home and Host Country Supervisors" in *International Financial Instability* (2007), p.212.

The new regime in Singapore, enacted after the global financial crisis, curtails freedom of choice as it requires foreign banks to incorporate their retail banking operations in Singapore if their retail presence exceeds certain thresholds. Such is the case if the bank's share of resident non-bank deposits amounts to at least 3 per cent and it has at least 150,000 depositors with accounts of no more than SGD 250,000.[36]

Singapore is no outlier in this respect. Requirements for incorporation of foreign banks, especially if they are considered systemically important for the host market, have become more common in recent years.[37] Resolution regimes, in particular, are sources of distrust between home and host regulators. Differences among national bank resolution mechanisms—or in lack thereof among ordinary insolvency regimes—impede restructurings and recoveries of systemically important parts of GSIBs.[38]

Alignment of regulatory standards and transnational co-operation

The obvious solution for these dilemmas is a stronger alignment of national regulatory standards and cross-border co-operation among regulators. Risks stemming from banks, especially SIBs, are the same throughout the world,[39] and this fact argues strongly in favour of concerted regulatory action. While alignement of standards of prudential bank supervision and transnational co-operation among regulators and central banks have existed since the establishment of the BCBS in 1974,[40] financial centres have recently raised such collaberation to a whole new level. Both principles are intertwined: convergence of applied standards of bank regulation is the precondition for effective cooperation, and aligned regulatory standards are of little practical value if host and home country supervisors do not look at banks whose risks they share from a consolidated perspective.[41] The progress that has been achieved so far will be critically discussed in the following parts.

The world's GSIBs

The FSB and BCBS jointly publish a list of GSIBs that is annually updated. These banking groups are further categorised by five levels of systemic relevance—"buckets" in the language of the FSB. Bucket five ranks highest, bucket one lowest in global systemic relevance.[42] The most recent list of November 2015 identifies 30 banking groups as GSIBs. The Agricultural Bank of China was added

[36] MAS, "Proposed Framework for Systemically Important Banks in Singapore", Consultation Paper (June 2014), *http://www.mas.gov.sg* [Accessed 14 December 2016].

[37] In detail on "subsidiarization", see K. D'Hulster, "Cross Border Banking Supervision Incentive Conflicts in Supervisory Information Sharing between Home and Host Supervisors" World Bank Policy Research Working Paper 5871 (2011), pp.24–26; Hüpkes and Devos, "Cross-border Bank Resolution" in *International Monetary and Financial Law* (2010), para.17.13.

[38] On such differences see Herring, "Conflicts between Home and Host Country Supervisors" in *International Financial Instability* (2007), p.209.

[39] Bossu and Chew, "'But we are Different!'" (September 2015) p.4, *https://www.imf.org/external/pubs/cat/longres.aspx?sk=43274.0* [Accessed 14 December 2016].

[40] On the establishment and development of the BCBS, see Basel Committee on Banking Supervision, "A brief history of the Basel Committee" (Bank for International Settlements 2014)*http://www.bis.org/bcbs/history.pdf* [Accessed 14 December 2016].

[41] Compare Le Pan, "Regulatory Challenges" in *Cross-Border Banking* (2006), pp.33–38.

[42] Basel Committee on Banking Supervision, "Global systemically important banks: updated assessment methodology and the higher loss absorbency requirement" (Bank for International Settlements 2013), *http://www.bis.org/publ/bcbs255.pdf* [Accessed 14 December 2016].

in 2014 to the 2013 list of 29, and in 2015 and 2016 a number of banks were moved in higher and lower buckets, leaving the total of 30 GSIBs unchanged, but increasing the total in bucket 2 to 6 and reducing the number in bucket 1 to 18.[43]

The list comprises eight US banks, four banks each from China, France and the UK, three Japanese banks, two Swiss banks and one bank each from Germany, Italy, the Netherlands, Spain and Sweden. In total, 30 GSIBs are headquartered in 11 jurisdictions. This rather low number of GSIB home jurisdictions might facilitate international co-operation as will be explained below (see section "Proposals").

Depending on the bucket in which they have been included, GSIBs are required to maintain higher or lower amounts of additional loss absorbency capital. The groups ranking highest in global systemic relevance are JP Morgan Chase and Citigroup (both US) in bucket four, therefore each requiring 2.5 per cent of additional Common Equity Tier (CET) 1 capital, followed by Bank of America (US), BNP Paribas (F), HSBC (UK) and Deutsche Bank (D) in bucket three and thus each stipulated to hold an additional 2 per cent of CET1.

Convergence of substantive law of bank regulation

Harmonised standards for bank regulation promise to improve stability of the banking sector worldwide. The Basel principles, currently at the stage of Basel III, seek to establish a worldwide standard for risk-weighted equity requirements and crisis-resistant liquidity reserves for banks.[44]

While the most significant steps towards a sounder financial system are taken in regions that were worst affected by the global financial crisis, i.e. in the US and Europe, the Basel standards are not only implemented in these regions, but worldwide. The reasons are obvious. Most jurisdictions outside Europe and America, especially important financial centres in Asia, were spared the bitter transatlantic crisis experience. They felt the shockwaves of the crisis, but managed to overcome liquidity shortages with central bank measures, owing to the fact that their home banks did not hold (large) portions of the financial products that turned toxic in the US and Europe and led to massive asset write-downs and resulting solvency issues of US and European banks.[45] However, awareness exists that local banks can fail anywhere and that foreign banks, especially GSIBs, expose host markets to imported risk. An example of this effect is Singapore, where the regulator, the Monetary Authority of Singapore, is aware of the omnipresent threat of bank failures in general and Singapore's exposure to foreign banks, especially

[43] Financial Stability Board, "2015 update of list of global systemically important banks (G-SIBs)" (3 November 2015), *http://www.financialstabilityboard.org/wp-content/uploads/2015-update-of-list-of-global-systemically-important-banks-G-SIBs.pdf* [Accessed 14 December 2016] and "2016 list of global systemically important banks (G-SIBs)" (21 November 2016), *http://www.fsb.org/wp-content/uploads/2016-list-of-global-systemically-important-banks-G-SIBs.pdf* [Accessed 16 January 2017].

[44] Basel Committee on Banking Supervision, "Basel III: A global regulatory framework for more resilient banks and banking systems" (Bank for International Settlements 2010, rev. June 2011), *http://www.bis.org/publ/bcbs189.pdf* [Accessed 14 December 2016]; Avgouleas, *Governance of Global Financial Markets* (2012), pp.266–272; A.W. Hartlage, "The Basel III Liquidity Coverage Ratio and Financial Stability" (2012) 111 *Michigan Law Review* 453; N. Lyngen, "Basel III: Dynamics of State Implementation" (2012) 53 *Harvard International Law Journal* 519, 523–526.

[45] M. Carlson, B. Duygan-Bump and W. Nelson, "Why Do We Need Both Liquidity Regulations and a Lender of Last Resort? A Perspective from Federal Reserve Lending during the 2007–09 U.S. Financial Crisis", Finance and Economics Discussion Series 2015-011, Washington: Board of Governors of the Federal Reserve System (2015), p.15, *http://dx.doi.org/10.17016/FEDS.2015.011* [Accessed 14 December 2016].

GSIBs.[46] Such jurisdictions join the countries most affected by the crisis and adapt their regulation to the international consensus, especially the Basel III standards.[47]

Assimilation of rules of prudential bank supervision is nowhere more visble than in the EU. The European harmonisation process started more than 30 years ago and has constantly been intensified. The recent developments have, however, pushed harmonisation in the direction of uniformity. While bank regulation used to be addressed by EU directives that require implementation into national law, thereby creating a partially standardised regime, the new approach consists of uniform rules provided by the Capital Requirements Regulation (CRR),[48] complemented by the Capital Requirements Directive (CRD IV).[49] The current rules of bank regulation in the EU are therefore a combination of directly applicable uniform EU rules and national provisions based on harmonised EU principles.

The EU has thereby taken a big step in the direction of a Single Rule Book in bank regulation. Discrepancies, however, remain. The EU principle of minimum harmonisation in directives on bank regulation allows national legislators to regulate their institutions more strictly than required by EU law. Member States may, for instance, impose optional additional systemic risk buffers, e.g. additional capital requirements or define banks more widely than under EU rules, for example in an attempt to eliminate loopholes for shadow banking, but they are banned from applying equally high standards to foreign EU banks. For as long as foreign banks comply with the standards required in their home countries and these home countries have fully implemented all relevant EU rules, other EU regulators are not permitted to impose stricter standards.[50]

These principles are reflected in the process of bank licensing: banks are authorised by the authorities in the country where their headquarters are.[51] Such authorisation by the home country authorities serves as a "quality label" granting every authorised institution a "Single European Pass", permitting it to operate throughout the EU (and even EEA) by providing cross-border services or by establishment of branches without the need for prior authorisation by the host countries.[52] Exceptions apply to subsidiaries. Since subsidiaries with banking activities are locally incorporated entities, thus legal entities of the host country, they require licensing by the host country authorities. Such authorisation is granted on the basis of consultation with the supervisor in the parent's home country.[53]

While such principles of mutual recognition do not exist outside of the EU, host countries of foreign banks generally take into account the regulatory standards in their home jurisdictions. High standards for licensing and of day-to-day monitoring

[46] Monetary Authority of Singapore, "Objectives and Principles of Financial Supervision in Singapore" (April 2004, rev. April 2013), pp.5–7.

[47] On the progress in Singapore, see the Regulatory Consistency Assessment Programme of the BCBS of 2013 on Singapore, "Basel III capital regulations in Singapore assessment concluded by the Basel Committee" (Bank for International Settlements, 20 March 2013), *http://www.bis.org/press/p130320.htm* [Accessed 14 December 2016].

[48] Regulation 575/2013 [2013] OJ L176/1.

[49] Directive 2013/36 [2013] OJ L176/338.

[50] Compare J. Atik, "EU Implementation of Basel III in the Shadow of Euro Crisis" (2013–14) 33 *Review of Banking & Financial Law* 283, 320.

[51] The requirement for authorisation stems from art.8 CRD IV and the prohibition to accept deposits for any other person or undertaking than an authorised credit institution from art.9 CRD IV. On the responsibility of the home supervisor for the supervision of the bank, see art.49(1) CRD IV.

[52] CRD IV art.17 and Recital 19. For branches, see CRD IV art.35.

[53] CRD IV art.16(1).

in the home country justify lower entry standards by host regulators. Alignment of standards supports this effect.

Supervisory co-operation

In addition to such alignment of substantive law of banking regulation, the countries represented in the BCBS engage in data exchange among national supervisors and other competent authorities in order to discover and minimise risks of micro- and macroeconomic failures in the financial sector.[54] Collectively they seek to avoid bank collapses and market failures.

The FSB and BCBS have recommended to intensify co-operation of their members through supervisory colleges and rules for competence-sharing among the involved supervisors.[55] This recommendation is expected to result in the allocation of one supervisory college to every GSIB in which the supervisors of all or at least the most relevant jurisdictions in which the GSIB operates will engage in joint group-wide supervision, leading to close co-operation of each GSIB's "key supervisors".[56] The lead role will be exercised by the home supervisor of the GSIB.[57] The FSB sets and applies the rules to determine which institutions are GSIBs and provides an annually updated list (on the list, see subsection "The world's GSIBs" above). In addition, it assesses the resilience of these GSIBs to crises in regular stress tests simulating worst-case scenarios.[58] The colleges need to agree on substantial details such as the question which entities belonging to a financial group are relevant for transnational supervision and therefore included in consolidated supervision.[59]

Whereas these supervisory colleges are meant to facilitate the transnational monitoring of banks, they will not replace the national supervisors, and, consequently, all powers of enforcement will remain with the national authorities.[60] This corresponds to the lack of enforcement powers of the FSB that was established by inter-governmental agreements among its members and does not limit the sovereignty of its members, reducing its tasks to the submission of non-binding recommendations.[61] Compliance of members is assessed by FSB implementation reports to the G20 that are based on the members' reports to the FSB.[62] The FSB's strongest weapon is therefore mere "naming and shaming".[63] These facts have led to criticism of supervisory colleges for their lack of binding burden-sharing arrangements, potentially resulting in the outcome that co-operation in colleges

[54] For the list of members of the BCBS see Bank for International Settlements, "Basel Committee Membership", *http://www.bis.org/bcbs/membership.htm* [Accessed 14 December 2016].

[55] See the recommendations of the FSB, "Reducing the Moral Hazard Posed by Systemically Important Financial Institutions—FSB Recommendations and Timelines", pp.7 seq.; Avgouleas, *Governance of Global Financial Markets* (2012), pp.351–352; Andenas and Chiu, *The Foundations and Future of Financial Regulation* (2014), p.459.

[56] Weber et al., "Addressing Systemic Risk" (2014) 49 *Texas International Law Journal* 149, 169.

[57] Le Pan, "Regulatory Challenges" "Regulatory Challenges" in *Cross-Border Banking* (2006), p.36.

[58] Weber et al., "Addressing Systemic Risk" (2014) 49 *Texas International Law Journal* 149, 167.

[59] Bossu and Chew, "'But we are Different!'" (September 2015) pp.31–34, *https://www.imf.org/external/pubs/cat/longres.aspx?sk=43274.0* [Accessed 14 December 2016].

[60] Avgouleas, *Governance of Global Financial Markets* (2012), p.210.

[61] Davies, "Resolution of Cross-border Groups" in *Research Handbook on Crisis Management in the Banking Sector* (2015), p.272.

[62] FSB Report to the G20, "Towards full implementation of the FSB Key Attributes of Effective Resolution Regimes for Financial Institutions" (12 November 2014).

[63] Compare Davies, "Resolution of Cross-border Groups" in *Research Handbook on Crisis Management in the Banking Sector* (2015), p.273; Ferran and Alexander, "Can Soft Law Bodies be Effective?" (2010) 35 E.L. Rev. 751, 754–755.

will show little or no effect in serious crises whenever national interests are at stake.[64] Such concerns are based on the findings of the IMF, according to which memoranda of understanding failed to operate as planned during the global financial crisis.[65]

The radical solution for such inefficiencies is obvious. Vesting central supervision and—related to that—resolution powers in an existing or yet to be established international financial institution is the farthest reaching proposal for binding commitments among home and host nations of GSIBs. It has been suggested that the IMF or BIS should become an international supervisor and resolution authority for GSIBs and exercise these competences with binding effect on all member countries.[66] Whereas such proposals represent the most promising suggestion for a truly global regime, they seem unrealistic for as long as powerful countries do not gain from such substantial transfers of sovereign powers. To look at it from the perspective of the US, it seems that its status as an economic and financial heavyweight, especially as the provider of the global reserve currency, empowers it to ringfence its national market more effectively than it would be possible for smaller nations that depend on the presence of GSIBs in their markets. Such host states have strong incentives to support US agencies in monitoring the activities of US GSIBs operating in their markets.

To a lesser extent the same principles apply to the benefit of other main homes to GSIBs, especially the UK, France, China and Japan. Following from this, lead roles for home countries of GSIBs in multilaterally binding commitments among (major) home and host countries seem realistic.[67] Consequently, these nations, above all the US, seem to gain little from the establishment of a global regulator, supervisor and resolution authority, rendering such proposals academically beneficial, but currently merely hypothetical.

One exception of importance applies. The recent crisis revealed that co-operation among EU supervisors did not function as well as expected. Exchange of information and other ways of co-operation among supervisors was unsatisfactory.[68] These deficiencies in the EU regulatory system led first to the establishment of the European Banking Authority (EBA), meant to improve co-operation among EU supervisors, and, more importantly and recently, the euro area's new Banking Union regime.[69] On 1 November 2014, the ECB began exercising its new task as central supervisor of the global activities of presently 126 (as of November 2016) "Euro-SIBs" in 19 countries. This new regime has been denominated the "Single Supervisory Mechanism" (SSM), established and governed by the Single Supervisory Mechanism Regulation (SSMR).[70] Of equal practical importance is

[64] Avgouleas, *Governance of Global Financial Markets* (2012), p.210.

[65] IMF Staff Working Paper, "Cross-Border Bank Resolution: Recent Developments" (June 2014), p.6 (Box 1); E. Avougleas and C. Goodhart, "Critical Reflections on Bank Bail-ins" (2015) 1 *Journal of Financial Regulation* 1, 21.

[66] Garicano and Lastra, "Towards a New Architecture for Financial Stability" (2010) 13 *Journal of International Economic Law* 597, 619–620.

[67] Favouring the lead role of the home country (among others), see Westbrook, "SIFIs and States" (2014) 49 *Texas International Law Journal* 329, 349.

[68] Avgouleas, *Governance of Global Financial Markets* (2012), pp.263–266; Westbrook, "SIFIs and States" (2014) 49 *Texas International Law Journal* 329, 330.

[69] On the Banking Union, see E. Ferran and V. Babis, "The European Single Supervisory Mechanism" (2013) 13 *Journal of Corporate Law Studies* 255.

[70] Regulation 1024/2013 [2013] OJ L287/63.

the SSM Framework Regulation (SSMFR).[71] The SSMFR provides the rules for the co-operation between the ECB and the national supervisors and the rights and obligations of supervised entities and third parties.[72] It is a regulation of the ECB, i.e. a regulation of an executive organ of the EU, not of its legislator.[73] Resulting from the establishment of the SSM, a total of eight GSIBs are supervised centrally under the lead role of the ECB (four French, and one each from Germany, Spain, the Netherlands and Italy).[74]

Convergence of restructuring and resolution regimes

The financial crisis has left no room for doubt that the existing resolution regimes for financial institutions were insufficient to deal with failing SIBs.[75] SIBs are usually complexly structured groups of entities whose activities are diverse and global. Pre-crisis, national insolvency regimes inadequately addressed the issues resulting from this.[76] Only restructuring and resolution regimes tailored to the particular risks stemming from the banking business can provide solutions, and progress is visible in two respects. Current reforms of national regimes for failing banks are following what can be considered a new regulatory standard for bank resolution. In 2014, the FSB proposed its "Key Attributes of Effective Resolution Regimes for Financial Institutions",[77] and following their endorsement by the G20 the principles are now being broadly followed by national—and supranational—regulators in its 24 member countries and the EU.[78]

General developments

The Dodd-Frank Act has led to many significant reforms of the financial system in the US, inter alia to a new resolution regime.[79] The new resolution mechanism for systemically important financial institutions is called "Orderly Liquidation Authority" (OLA) and administered by the Federal Deposit Insurance Corporation (FDIC).[80]

While several EU countries reacted fast and introduced national bank resolution acts during the peak years of the crisis,[81] these national approaches were followed

[71] SSM Framework Regulation (ECB/2014/17) [2014] OJ L141/51.
[72] For the new tasks assigned to the ECB see SSMR arts 4, 9–18.
[73] The ECB's rule-setting competence in this matter follows from SSMR art.6(7).
[74] In bucket one, Group Banque Populaire CE (F), Group Crédit Agricole (F), Société Générale (F), ING Bank (NL), Santander (E) and Unicredit Group (I); in bucket three BNP Paribas (F) and Deutsche Bank (D).
[75] Westbrook, "SIFIs and States" (2014) 49 *Texas International Law Journal* 329, 332; T. Jackson and D. Skeel, "Dynamic Resolution of Large Financial Institutions" (2012) 2 *Harvard Business Law Review* 435, 436; Schillig, "Bank Resolution Regimes in Europe" (2013) 25 *European Business Law Review* 751, 751; Gordon and Ringe, "Bank Resolution in the European Banking Union" (August 2014), p.6.
[76] Weber et al., "Addressing Systemic Risk" (2014) 49 *Texas International Law Journal* 149, 164; Herring, "Conflicts between Home and Host Country Supervisors" in *International Financial Instability* (2007), p.209.
[77] Financial Stability Board, "Key Attributes of Effective Resolution Regimes for Financial Institutions" (15 October 2015), *http://www.financialstabilityboard.org/2014/10/r_141015* [Accessed 14 December 2016].
[78] See the list of 24 members plus the EU at *http://www.financialstabilityboard.org/about/fsb-members*. [Accessed 14 December 2016]. For implementation of FSB approaches in the EU-BRRD, see Schillig, "Bank Resolution Regimes in Europe" (2013) 25 *European Business Law Review* 751, 753.
[79] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No.111-203, 124 Stat. 1376 (2010); Jackson and Skeel, "Dynamic Resolution of Large Financial Institutions" (2012) 2 *Harvard Business Law Review* 435, 439; E. Putrikis, "Striking Changes in US Banking Supervision and Regulation" in *International Monetary and Financial Law* (2010), paras 9.37 to 9.40.
[80] Title II of the Dodd-Frank Act, 12 USC Ch.53 Subchapter II (§§5381–5394).
[81] For Germany and the UK see Schillig, "Bank Resolution Regimes in Europe" (2013) 25 *European Business Law Review* 751, 753; Gordon and Ringe, "Bank Resolution in the European Banking Union" (August 2014), p.6.

in May 2014 by the requirement to implement the EU bank recovery and resolution directive (BRRD).[82] While the BRRD rules of substantive law will apply in the entire EU, a special procedural regime will only affect participating Member States (PMS). The Single Resolution Mechanism (SRM) will create a procedural regime of joint planning and decision-making for financial institutions in the euro zone (and open to other EU states to join on a voluntary basis). It is part of the above-mentioned Banking Union and complements the SSM (see subsection "Supervisory co-operation" above) by providing similar mechanisms in resolution matters.[83]

The rules of the substantive law of BRRD and SRM pursue identical objectives and are in line with the FSB key attributes. They seek to ensure continuity of critical functions of financial institutions, avoid significant adverse effects on financial stability and protect public funds and depositors. To achieve impartial results for national and cross-border scenarios, these principles are complemented in the SRM by transfers of resolution powers to supranational decision-makers.[84] Essential competences are vested in institutions acting independently from Member States: the ECB, the European Commission and a newly created Systemic Risk Board (SRB), a European agency located in Brussels.

In addition to the convergence of national resolution regimes, regulators worldwide show their willingness to co-operate with each other to find solutions for what has been named the "most testing area for international coordination".[85] Experts from central banks, ministries of finance, supervisors and resolution authorities of all FSB members have established crisis management groups (CMGs) meant to produce agreements that provide the mechanisms for co-operation among national authorities to be applied to global systemically important financial institutions (GSIFIs) in times of crisis.[86]

Included in these agreements must be co-operation plans that contain the essential elements found in Annex 1 to the FSB Key Attributes.[87] Legislators or regulators must provide mechanisms that assure that every GSIB is subject to ongoing recovery and resolution planning.[88] The resolution authorities are required to assess the resolvability of each GSIB regularly and on a co-operative basis.[89] The outcome must be national planning that is reconcilable with group-wide recovery and resolution plans developed under the leadership of the bank's home resolution authority.[90]

On the UK, see also S. Dhama, J. Taylor and C. Proctor, "The Reform of Financial Regulation in the UK after the Crisis" in *International Monetary and Financial Law* (2010), paras 11.42 to 11.49.

[82] Directive 2014/59 [2014] OJ L173/190.

[83] The scopes of application of SSM and SRM are not identical: the SRM applies to financial institutions, the SSM only to banks.

[84] Compare Gordon and Ringe, "Bank Resolution in the European Banking Union" (August 2014), p.8.

[85] Citing Davies, "Resolution of Cross-border Groups" in *Research Handbook on Crisis Management in the Banking Sector* (2015), p.261. Similar the famous statement of Mervyn King, former governor of the Bank of England, that "global banks are international in life but national in death".

[86] Financial Stability Board, "Key Attributes of Effective Resolution Regimes for Financial Institutions" (15 October 2015), p.8 at pp.14ff, *http://www.financialstabilityboard.org/2014/10/r_141015* [Accessed 14 December 2016].

[87] Financial Stability Board, "Key Attributes of Effective Resolution Regimes for Financial Institutions" (15 October 2015), Key Attribute 9 at p.14 in combination with I-Annex 2.

[88] Financial Stability Board, "Key Attributes of Effective Resolution Regimes for Financial Institutions" (15 October 2015), Key Attribute 11 at p.16 in combination with I-Annex 4.

[89] Financial Stability Board, "Key Attributes of Effective Resolution Regimes for Financial Institutions" (15 October 2015), Key Attribute 10 at p.15 in combination with I-Annex 3.

[90] Financial Stability Board, "Key Attributes of Effective Resolution Regimes for Financial Institutions" (15 October 2015), I-Annex 4 at 1.5, p.43.

The above-mentioned criticism for lack of enforceability of FSB co-operation applies equally in resolution as in supervision matters. Nonetheless, progress reports indicate that the soft law approach is leading to substantial progress. The 24 FSB members as well as the EU show willingness to comply with the key attributes. Such compliance creates a reliable framework of internationally converged standards under which GSIBs can operate and supervisors communicate more easily. However, compliance by way of implementation of Key Attributes says little about how well co-ordination among members would function in the acute crisis of a GSIB. Joint plans for the co-ordinated resolution of GSIBs drafted by the members of GMCs are subject to their enforcement by national authorities within the boundaries of their jurisdictions. Whether all national authorities will adhere to prearranged plans in times of crisis remains to be seen.

Even so, there is reason for cautious optimism. Shared key elements of national resolution regimes may reduce the need for unilateral action. Provisions for bail-ins of creditors in all national restructuring and resolution regimes will likely reduce the need for bailouts. This might decrease the level of factual pressure exercised by the public on national authorities and give them more leeway to co-operate transnationally,[91] especially if the bailed-in creditors are predominantly international financial companies.

Trend of convergence of national resolution regimes

The global trend to align responses to insolvent or nearly insolvent banks is obvious. Leaving banks to their own devices has never been an option. If banks could be treated like other companies or company groups, equity owners would be wiped out and all unsecured creditors bailed-in pursuant to seniority, i.e. their claims reduced or satisfied pro rata. But banks can never simply be liquidated like other business entities. Their resolution requires the survival of systemically relevant parts.[92]

At the same time, however, regulators worldwide seek to avoid bailouts of SIBs as commonly seen during the peak of the financial crisis.[93] The elimination or (more realistically) minimisation of bailout costs promises to reduce negative externalities and moral hazard because incentives for private monitoring increase.[94] It is therefore not promising to increase the amounts guaranteed by deposit insurance schemes or broaden their scopes of application. For practical as well as policy reasons, above all the need for reliance on private monitoring from informed and experienced creditors, deposit insurance must be limited to retail depositors and capped at reasonable amounts. This means, of course, that the positive effects stemming from deposit insurance depend on the scale of retail financing of the

[91] Compare (yet sceptical in his assessment) Davies, "Resolution of Cross-border Groups" in *Research Handbook on Crisis Management in the Banking Sector* (2015), p.274.

[92] Compare Westbrook, "SIFIs and States" (2014) 49 *Texas International Law Journal* 329, 331.

[93] Bailouts now commonly depend on parliamentary resolutions; see for the US Federal Reserve Act s.13(3) as amended by the Dodd Frank Act. See also UK Banking Act 2009 s.228; Carlson, Duygan-Bump and Nelson, "Why Do We Need Both Liquidity Regulations and a Lender of Last Resort?" (2015), p.2, *http://dx.doi.org/10.17016/FEDS.2015.011* [Accessed 14 December 2016].

[94] Weber et al., "Addressing Systemic Risk" (2014) 49 *Texas International Law Journal* 149, 170; Schillig, "Bank Resolution Regimes in Europe" (2013) 25 *European Business Law Review* 751, 755; F. Allen et al., "Moral Hazard and Government Guarantees in the Banking Industry" (2015) 1 *Journal of Financial Regulation* 30, 31; Avgouleas and Goodhart, "Critical Reflections on Bank Bail-ins" (2015) 1 *Journal of Financial Regulation* 1, 4–5, 20, 27.

banking sector. Under current trends where banks, especially GSIBs, replace retail deposits by other sources of debt funding, [95] the significance of deposit insurance decreases and incentives of creditors increase to withdraw or discontinue reinvesting their money on a roll-over basis when a crisis materialises.[96]

The bail-in approach

Regulators worldwide seem to agree that bail-ins must form an essential part of every resolution since they imitate mechanisms that form part of insolvency procedures: stakeholders are held liable for risks they choose and competition-distorting advantages for SIBs caused by implied bailout guarantees and translating into lower financing costs are reduced.[97]

The immediate effect of bail-ins consists of a reduction of debt, but it seems less clear whether their further indirect objective can be achieved: the prevention of runs. Under the assumption that stakeholders will act rationally, it seems possible to avoid runs if running seems irrational in light of resolution measures that effectively eliminate hazards for creditors. Bail-ins of unsecured, long-term creditors that cannot run reduce the amount of debt and pave the way for the bank's return to solvency, thereby in theory also reducing incentives for secured and even unsecured short-term creditors to run. Whether regulators can rely on rational behavior of depositors and other creditors seems, however, uncertain, especially in light of events during the recent crisis. A run on Northern Rock was triggered when the bank merely received Emergency Liquidity Assistance (ELA) by the Bank of England in 2007.[98]

According to generally applied principles, such assistance is generally limited to liquidity shortages of solvent banks.[99] The only reason for depositors and other creditors in this situation to run was the fear that other creditors might run and thereby increase the liquidity shortage of Northern Rock, potentially turning the bank's liquidity into a solvency crisis. Since central bank ELA seeks to prevent exactly that (by preventing the need for fire-sales of assets), even this fear seemed irrational—and yet the run occurred. It might therefore well be that bail-ins may not eliminate the need for temporary freezes of claims of short-term creditors either.

Ideally, the bail-in of some creditors will suffice to return the bank to solvency and to re-establish confidence in its soundness. In such ideal scenarios the solvency and liquidity issues of the bank can be overcome if markets restart to provide financing.[100] Such returns to market financing are essential because central banks cannot support insolvent banks. While central banks have the unlimited monetary fire-power to provide financial help in situations of bank crises, their mandates

[95] Armour et al., "Principles of Financial Regulation", ECGI Law Working Paper No.277/2014 (December 2014), p.3, SSRN, *http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2526740* [Accessed 14 December 2016].

[96] Compare Gordon and Ringe, "Bank Resolution in the European Banking Union" (August 2014), p.3.

[97] Bailouts can be impossible when sovereigns lack financial means; see Schillig, "Bank Resolution Regimes in Europe" (2013) 25 *European Business Law Review* 751, 756. Critical on bailouts, see Avgouleas and Goodhart, "Critical Reflections on Bank Bail-ins" (2015) 1 *Journal of Financial Regulation* 1, 12–20 (especially 15).

[98] In detail on ELA for Northern Rock, see Campbell and Lastra, "Revisiting the Lender of Last Resort" (2008–2009) 24 *Banking and Finance Law Review* 453, 473–477.

[99] Carlson, Duygan-Bump and Nelson, "Why Do We Need Both Liquidity Regulations and a Lender of Last Resort?" (2015), p.10, *http://dx.doi.org/10.17016/FEDS.2015.011* [Accessed 14 December 2016].

[100] Jackson and Skeel, "Dynamic Resolution of Large Financial Institutions" (2012) 2 *Harvard Business Law Review* 435, 454.

restrict them from recaptialisation of banks. Central banks are limited to their traditional task as providers of ELA.[101] As said, ELA liquidity injections are subject to a number of conditions, the two most important of which are the solvency of the borrowing bank and adequate collateralisation.[102] While bail-ins improve the solvency of banks, it seems unlikely that without further measures the banks will meet these ELA requirements.[103] Whereas central banks provided liquidity help for financial institutions in the past whose solvency status was unclear, this took place in few cases and in situations where no other measure seemed available to prevent a systemic collapse of the financial system.[104] Such rescue efforts by central banks may become unavoidable in dramatic situations, but monetary financing for insolvent banks must remain a stigmatized practice and therefore never become a standard tool applied in the restructuring and resolution of banks.[105] The US legislator has reacted to events during the global financial crisis. The Dodd-Frank Act limits lending of last resort of the Federal Reserve System to providing liquidity to the financial system as a whole while aiding individual troubled institutions is now prohibited.[106] Such lending to failing institutions is now an exclusive task of the FDIC.[107]

Losses and consecutive bail-ins reduce the balance-sheets of banks and may shrink them substantially. This is tolerable and even intended since rescue efforts strive to guarantee the survival of the core functions of the bank. If bail-ins enable the banks to meet their liabilities from deposits, continue to lend and execute deposit-related payment services,[108] the recovery can be considered a success.

Application of resolution tools

Bail-ins may be insufficient and more drastic measures unavoidable, especially in situations where market solutions are unavailable, e.g. takeovers of ailing banks by healthy banks are impossible, be it due to the size of the crisis-struck bank or because the entire sector is affected by a large-scale crisis.

[101] Campbell and Lastra, "Revisiting the Lender of Last Resort" (2008–2009) 24 *Banking and Finance Law Review* 453, 465–466.

[102] Carlson, Duygan-Bump and Nelson, "Why Do We Need Both Liquidity Regulations and a Lender of Last Resort?" (2015), pp.3–6, *http://dx.doi.org/10.17016/FEDS.2015.011* [Accessed 14 December 2016]; V. Acharya and D. Backus, "Private Lessons for Public Banking—The Case for Conditionality in LOLR Facilities" in V. Achary and M. Richardson (eds), *Restoring Financial Stability: How to Repair a Failed System* (New York: Wiley Publishers, 2009), p.305 at pp.319–320.

[103] Similar on the principle that central banks should never bear bank insolvency risks, but different in their ultimate assessment that central banks are best suited to provide help, see Gordon and Ringe, "Bank Resolution in the European Banking Union" (August 2014), p.43.

[104] On ELA to Bear Stearns, AIG and other institutions by the US FED-system and examples from Switzerland and the UK, see D. Domanski, R. Moessner and W. Nelson, "Central banks as lender of last resort: experiences during the 2007–2010 crisis and lessons for the future", Finance and Economics Discussion Series Divisions of Research & Statistics and Monetary Affairs, Federal Reserve Board (2014), pp.7–8 and 26–30.

[105] Similarly Campbell and Lastra, "Revisiting the Lender of Last Resort" (2008–2009) 24 *Banking and Finance Law Review* 453, 470.

[106] Federal Reserve Act s.13(3)(B)(i); Carlson, Duygan-Bump and Nelson, "Why Do We Need Both Liquidity Regulations and a Lender of Last Resort?" (2015), p.27, *http://dx.doi.org/10.17016/FEDS.2015.011* [Accessed 14 December 2016].

[107] Carlson, Duygan-Bump and Nelson, "Why Do We Need Both Liquidity Regulations and a Lender of Last Resort?" (2015), p.29, *http://dx.doi.org/10.17016/FEDS.2015.011* [Accessed 14 December 2016]; Domanski, Moessner and Nelson, "Central banks as lender of last resort", Finance and Economics Discussion Series Divisions of Research & Statistics and Monetary Affairs, Federal Reserve Board (2014-110), p.23.

[108] On these core functions and their survival in bank recoveries, see Gordon and Ringe, "Bank Resolution in the European Banking Union" (August 2014), p.10.

Restructuring mechanisms have been given catchy names such as "asset transfer tool" or "bridge bank" and "bad bank", but such terms cannot disguise the fundamental issues that come with such methods. If they are applied to give resolution authorities more time to apply substantial bail-ins or to prepare the absorption of the bank in its entirety by a competitor, bailouts can be avoided. In all other cases, however, their application weighs heavily on public budgets. Resolution authorities must guarantee the survival of the bank's core parts. Two options are available. If the bank seems capable to return to sustainability, its debt except all (retail) deposits is moved to the "bad bank", so are its non-performing ("toxic") assets, and retail depositors can continue to use their deposit accounts for payment transactions and cash withdrawals, while performing borrowers can rely on their negotiated loan agreements. This revival depends on recapitalisation by the public sector, and the debt looming in the bad bank may trigger further strains on taxpayers' money if for reasons of financial stability or other policy considerations debt write-downs and write-offs can only cautiously be applied. The same results follow from option two, under which the original bank is liquidated while the core parts survive in a bridge bank, usually run by the bank supervisor or resolution authority until a purchaser for the entire bank or its business is found.

To alleviate the burden on public budgets, sector-specific funding mechanisms for bank insolvencies are introduced or discussed in several parts of the world. The most current example is the EU where the BRRD obliges every Member State to establish national "resolution financing arrangements" to which all banks contribute.[109] For members of the euro area, a joint mechanism funded by its banks, called the Single Resolution Fund (SRF), has come into existence in 2016 and replaces the existing national funding mechanisms. Seven further EU countries (all remaining EU countries except Sweden and the UK) have opted into the SRF and will therefore combine their national arrangements with the joint fund.[110]

The combination of bail-ins and contributions by cash pools funded by the banking sector will ease the burdens on public budgets. These mechanisms will work well for smaller banks. The bigger the bank and the higher its systemic relevance, however, the more likely it seems that the hazards cannot be contained without additional assistance from taxpayers. In the US, the Treasury has the competence to grant such funding,[111] and in the euro zone the ESM has the mandate to support banks directly.[112] For GSIBs serious cross-border issues arise that will be discussed immediately below.

Co-ordination among resolution authorities—general principles

While the national solutions that have sprung to life around the globe have hardly been tested in practice, the more difficult issue of cross-border bank resolutions requires regulators' attention. So far, bank resolutions have been treated like other cross-border insolvencies. A multiple point of entry (MPoE) approach divides at

[109] Denominated a "European system of financing arrangements" as required by Title VII (arts 99–107) of BRRD.

[110] See Council of the EU, Press Release, "Member states sign agreement on bank resolution fund" (21 May 2014).

[111] Bailouts are supposed to be avoided if possible, but if unavoidable public funding of banks can be approved by Congress. See Federal Reserve Act s.13(3)(B)(i).

[112] On the ESM funding capacity to banks, see *http://www.esm.europa.eu* [Accessed 14 December 2016], and in more detail "FAQ on the main features of the future ESM direct bank recapitalisation instrument".

least the foreign subsidiaries of banks from their home country parents and leads to separate proceedings. In extreme cases, not uncommon during the financial crisis, national resolution authorities do not co-ordinate their efforts.[113] Even foreign branches are not necessarily included in home country resolutions. Only jurisdictions pursuing a universal approach treat branches as parts of companies for insolvency purposes, whereas a territorial approach separates branches from their foreign headquarters.[114]

If resolutions of banks are a national task, then risks stemming from GSIBs must be addressed on the national level. The national authorities will seek to avoid bailouts and therefore rely on ringfencing requirements that require foreign banks to locally incorporate and possess sufficient debt absorbing assets.[115]

Such national measures are not negative per se. They increase the resilience of national markets to crises of GSIBs, thereby reducing cross-border contagion and contributing to global financial stability. Efficient national ringfencing can ultimately reduce the transnational spread of financial risk. Their side effects, however, are obvious: truly global banking cannot exist in national environments that reduce international banks to groups of national (i.e. locally incorporated and ringfenced) banks united by holding structures. National solutions disintegrate global financial markets, thereby forcing GSIBs to allocate assets not where they are needed most and promise the highest returns, but where regulation requires it.

Whereas under restrictive national models global strategies can be pursued and synergies still exist, their benefits are limited as compared with truly global models where internationally operating banks open branches in multiple jurisdictions and are scarcely restricted from steering their local operations from their foreign headquarters.[116]

The gravest disadvantage of fragmented resolution regimes, however, shows in situations in which whole banking groups face serious difficulties. Co-ordinated restructuring efforts may enable the survival of most of the group's entities. Transnationally co-ordinated creditor bail-ins and equity write-downs may well prevent the collapse of the global group and save most of its franchise value. This is not only the preferable outcome for the banking group, but also for financial stability on the global and most likely also on every national level. A co-ordinated (fast) successful restructuring and therefore survival of the group will prevent panic reactions and therefore the perilous contagious effects that are at the core of regulatory concerns about international financial groups.

Global approaches that will permit GSIBs to operate without major restrictions seem possible but will require clear transnational co-ordination among regulators. During the global financial crisis, national authorities found themselves poorly prepared for the challenges stemming from failing GSIBs. National ringfencing had been unpopular prior to the crisis and mechanisms for cross-border co-operation

[113] Davies, "Resolution of Cross-border Groups" in *Research Handbook on Crisis Management in the Banking Sector* (2015), p.262.

[114] Hüpkes and Devos, "Cross-border Bank Resolution" in *International Monetary and Financial Law* (2010), paras 17.19 to 17.25.

[115] F. Lupo-Pasini and R. Buckley, "International Coordination of Cross-Border Bank Bail-ins: Problems and Prospects" (2015) 16 *European Business Organisation Law Review* 203, 221.

[116] Similarly Westbrook, "SIFIs and States" (2014) 49 *Texas International Law Journal* 329, 346; Ferrarini and Chiarella, "Common Banking Supervision in the Eurozone" (August 2013), pp.12–13; Avgouleas and Goodhart, "Critical Reflections on Bank Bail-ins" (2015) 1 *Journal of Financial Regulation* 1, 21.

in resolution matters were uncommon if not non-existent. These lapses resulted in positive externalities for foreign creditors if banks were bailed out and negative externalities when national regulators favored national creditors. During the crisis years, regulators resolved banks along jurisdiction lines, thereby ignoring that transnationally coordinated efforts might have saved the banks and left groups of financial institutions overall better off. While some local creditors benefitted from such unilateral actions, globally aligned approaches could have left creditors in their entirety better off.[117]

If such efficiency considerations argue in favour of co-ordinated approaches to the resolution of transnationally operating banks, inevitably the next question must be how to organise the co-operation amongst regulators. The widely recommended solution is the Single Point of Entry (SPoE) approach. It treats the entire financial group as a single entity for resolution purposes and vests the lead role in one jurisdiction.[118]

The SPoE aims at the survival of the core banking activities in global financial groups. The promoted concept foresees that the liabilities owed by bank subsidiaries to the parent are written off. Unsecured creditors of the parent will be bailed-in and become equity-holders (of the parent if it survives or of the subsidiary) while shareholders of the parent will be wiped out in either case. All systemically relevant parts of the group must be held or moved to the subsidiaries to guarantee their survival independently from the situation of the parent.

If the subsidiaries are exposed to external liabilities, i.e. not exclusively financed by the parent and other group entities, complications arise. Such local creditors would generally require separate national resolution proceedings, but such fragmentation of proceedings would counteract the purpose of the SPoE. The proposed solution is that such liabilities are sent upstream to the parent.[119] If the holding is liquidated, the surviving subsidiaries will start operating independently or become part of a new holding structure, usually by integration into other financial groups.[120]

This approach functions best in a holding structure where the parent raises and allocates debt to the entire group. In this scenario, the holding company is liable to creditors while other entities in the group owe their debt to the holding. This is the predominant structure of financial groups headquartered in the US.[121] Stemming from the limitations for financial activities of banks under the Glass-Steagall Act, the core functions of banks are generally reserved to the entity with a bank license in a financial group structure.[122] When the US legislator eased the strict separation of commercial and investment banking, the ban on important investment bank

[117] Compare Davies, "Resolution of Cross-border Groups" in *Research Handbook on Crisis Management in the Banking Sector* (2015), pp.262–263; Gordon and Ringe, "Bank Resolution in the European Banking Union" (August 2014), p.6.

[118] Strongly in support of one regulator's lead role, see Westbrook, (n 10) 348.

[119] Davies, "Resolution of Cross-border Groups" in *Research Handbook on Crisis Management in the Banking Sector* (2015), p.262.

[120] Gordon and Ringe, "Bank Resolution in the European Banking Union" (August 2014), p.15.

[121] See Gordon and Ringe, "Bank Resolution in the European Banking Union" (August 2014), p.15.

[122] Glass-Steagall entered into force in 1933 and was appealed in substantial parts in 1999 by the Gramm-Leach-Bliley Act; see Armour et al., "Principles of Financial Regulation", ECGI Law Working Paper No.277/2014 (December 2014), p.2, SSRN, *http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2526740* [Accessed 14 December 2016]; R. Carnell, J. Macey and G. Miller, *The Law of Financial Institutions*, 5th edn (Wolters Kluwer Law and Business, 2013), pp.25–26 (also on the remaining restriction that the same entity may not accept deposits and underwrite securities).

activities for deposit-taking banks remained in force. This required the structural separation of investment and commercial banking and resulted in group structures with holding companies at the top of the group and separate subsidiaries for core and non-core banking tasks below.[123] Dodd-Frank renders such commonly found structures mandatory for SIFIs. SIFIs must be held by US-incorporated holding companies, a requirement compulsory for domestic- and foreign-headquartered SIFIs.[124]

The approach works similarly well in national and cross-border scenarios if a US holding company sits at the top of US financial groups and some of the local and foreign incorporated subsidiaries hold the systemically relevant parts of the group and resolution measures are not executed nationally.[125]

The latter aspect underlines the most important element of any SPoE regime: the unconditional commitment of all national authorities to transnational rescue and resolution efforts. National legislators must ensure that resolution authorities are not bound by national interests when transnational rescue efforts might seem less advantageous to national interests than unilateral action. Especially the home country might seem better off if it ignores (some) foreign subsidiaries or branches and discriminates against foreign creditors, especially in a situation where the liquidity for the entire global presence of the group has been (predominantly) provided by the home country holding. To countervail unilateral national action, all involved authorities must nationally be authorised and transnationally (i.e. on a bi- or multilaterally binding basis) be obliged to act in the overall interests of all affected jurisdictions.[126] A model for such obligations to co-operate can be found in art.87 BRRD under which the authorities of all EU Member States must issue their orders with regard to the interests of all other impacted Member States.

The situation becomes, however, more difficult when GSIBs consist of groups without such clear top-to-bottom holding structures. This is a common model in many parts of the world and comes with less structured group financing. Subsidiaries are in these instances (partially) self-funded and therefore exposed to external debt.[127]

In such scenarios, the SPoE is not impossible. The above-mentioned proposal of sending liabilities and assets upstream in order to enable the home country resolution authority to exercise resolution procedures for the group could provide feasible mechanisms even in such instances. However, the need for SPoE may seem less evident here. The more independent the presence of the GSIB in the host country, the better the subsidiary seems prepared to survive without the group and vice versa.[128] It could even seem implausible to apply the SPoE if a self-funded subsidiary faces insolvency as this would require bailing in subordinated creditors

[123] Gordon and Ringe, "Bank Resolution in the European Banking Union" (August 2014), p.14.

[124] Lupo-Pasini and Buckley, "International Coordination of Cross-Border Bank Bail-ins: Problems and Prospects" (2015) 16 *European Business Organisation Law Review* 203, 218.

[125] Solvency is determined on the group level. Group level insolvency will result in administration by the FDIC: see s.38 FDIC Act.

[126] On the entire paragraph see Davies, "Resolution of Cross-border Groups" in *Research Handbook on Crisis Management in the Banking Sector* (2015), pp.267–268; Ferrarini and Chiarella, (n.13) 15.

[127] Lupo-Pasini and Buckley, "International Coordination of Cross-Border Bank Bail-ins: Problems and Prospects" (2015) 16 *European Business Organisation Law Review* 203, 219–220.

[128] Davies, "Resolution of Cross-border Groups" in *Research Handbook on Crisis Management in the Banking Sector* (2015), pp.270–271; Lupo-Pasini and Buckley, "International Coordination of Cross-Border Bank Bail-ins: Problems and Prospects" (2015) 16 *European Business Organisation Law Review* 203, 220.

of the parent for the sole benefit of those of the subsidiary.[129] However, in this respect the interdependence of cause and effect should not be ignored: subsidiaries are often structured in a way that grants them independence from the rest of the group because of national ringfencing requirements. Unilateral national approaches limit the options of GSIBs in host countries, and they result, as explained, from the lack of transnationally binding co-ordination efforts among regulators. Binding commitments to SPoE approaches would reduce the need for national ringfencing and might well lead to subsidiaries in host jurisdictions that are strongly integrated in the GSIB's global group structure.

Proposals—lead responsibility of home jurisdictions

The purpose of this article is not to decide whether a universal regime that eliminates the need for (substantial) national ringfencing is the preferable option. It also does not seek to explain in which situations the SPoE approach seems most beneficial to all national regulators. The following proposal assumes that good reasons for co-ordinated SPoE approaches exist, not necessarily in each individual case, but overall as they provide a reliable framework that will be received positively and therefore create confidence in the financial sector.[130] Instead, the article seeks to contribute to the discussion about viable options for reliable co-operation among regulators.

Since the SPoE resolves and restructures the group from top to bottom, entrusting the lead role in the home jurisdiction, it seems intuitive to task the home jurisdictions with the organisation of a binding structure for all involved nations. To achieve this, a shift of priorities seems unavoidable. The current global trend of hedging against imported systemic risk includes the home jurisdictions of GSIBs, shown by the US requirements for foreign SIFIs and the bilateral agreements entered into or currently negotiated between the US and other nations. However, this list currently only contains other home countries of GSIBs.[131] This seems to indicate that the parties to these agreements are driven by the wrong incentives. They seek to protect their jurisdictions from *imported* risks—home countries of GSIBs mutually export and import such risks—instead of taking responsibility for their *exported* risks. The financial landscape calls for bilateral agreements between the home countries of GSIBs and the nations that are exposed to their risks, leading to the assumption of responsibility by home states for the global activities of "their" GSIBs.

How collaboration in cross-border resolution of GSIBs will look needs to be clearly defined. The SPoE approach seems promising, but it requires clear rules to which all national regulators must commit.[132] The practice of regulators, based on the FSB key attributes, to jointly draft recovery and resolution plans in CMGs

[129] Davies, "Resolution of Cross-border Groups" in *Research Handbook on Crisis Management in the Banking Sector* (2015), p.271.

[130] Compare Garicano and Lastra, "Towards a New Architecture for Financial Stability" (2010) 13 *Journal of International Economic Law* 597, 620.

[131] Andenas and Chiu, *The Foundations and Future of Financial Regulation* (2014), pp.57–58; Gordon and Ringe, "Bank Resolution in the European Banking Union" (August 2014), p.17: agreements of the US with the UK, Switzerland and Germany.

[132] Similar, Lupo-Pasini and Buckley, "International Coordination of Cross-Border Bank Bail-ins: Problems and Prospects" (2015) 16 *European Business Organisation Law Review* 203, 222, 224, but different on the role of international law.

will have to be complemented by binding commitments among national regulators. While host nations must commit to abstaining from any efforts to seize assets located in their jurisdictions to secure the claims of national creditors, home nations must guarantee the survival of all systemically relevant functions of the bank in pursuit of the interests of all creditors at home and abroad and of global stability. In addition, contributions from either side for the recapitalisation of surviving entities must be pre-defined.

Such commitments promise to result in efficient competition among regulators and GSIBs. Credible commitments by nations will provide incentives for GSIBs to locate their headquarters in such committed countries, and that for two reasons: extravagant unilateral ringfencing against imported risks by GSIBs would seem unnecessary and counter-productive. Doing business in host countries might therefore become easier and cheaper for GSIBs. Additionally, financing costs will likely decrease since markets will react positively to credible commitments by home countries. This promises to improve capacities of GSIBs to contribute substantially to sector-specific funding mechanisms in their home and host countries, making these funds reliable sources for the recapitalisation of restructured financial groups. Additionally, credible financial commitments of home countries will require their regulators to prevent GSIBs from growing out of proportion and becoming "too big to fail" and "too big to rescue".[133]

Based on the FSB-list of GSIBs, such developments do not seem unrealistic. The 2016 list shows that the world's GSIBs are headquartered in 11 countries. The US is the biggest "exporter" of systemic risk with 8 GSIBs, followed by the UK, France and China with 4 GSIBs each, Japan with 3 GSIBs and a few continental European countries (Spain, Germany, Italy, the Netherlands, Switzerland and Sweden) with 2 or one GSIB(s). Such a small group of nations seems well suited for the leadership role of home nations required for such a regime. A global SPoE regime would seem realistic if these countries committed to their lead roles in the resolution of their GSIBs regardless of whether this would leave their own creditors, financial markets and taxpayers better or worse off in comparison with unilateral action.

The resulting question is how "binding" is to be understood. In lack of international authorities or courts with jurisdiction over such commitments, bank resolution agreements between and among states face the general issues related to treaties: their enforceability cannot be guaranteed. The only viable option is to raise "naming and shaming" to new levels. Unreliable conduct must be punished by host nations and GSIBs alike. If home nations decline to commit to host nations of their GSIBs, host nations will be enticed to establish heavy national safeguards.[134] This will result in negative consequences for GSIBs and provide incentives for them to move their headquarters to jurisdictions with better commitment records. If host nations breach their commitments and, for instance, seize assets instead of allowing them to be transferred to the home jurisdiction where co-ordinated resolution procedures are executed, home nations should jointly exercise their regulatory powers over GSIBs to limit or even prevent their operations in the

[133] Westbrook, "SIFIs and States" (2014) 49 *Texas International Law Journal* 329, 354.

[134] Similar, see Westbrook, "SIFIs and States" (2014) 49 *Texas International Law Journal* 329, 352: host countries will only admit SIBs for whom the home countries have entered into commitments to provide substantial means for resolution.

defiant host state. Binding can therefore not be understood as legally enforceable, but as reliable and subject to serious factual consequences in case of breach.

Whereas it seems unrealistic that nations would agree to transfers of regulatory powers to international institutions, at least outside the eurozone, the proposal here is aimed at an entirely different approach. The lead nations in such transnational commitments would not lose but gain in influence, above all the US, and smaller nations have long shown their willingness to accept the superior role of home nations of GSIBs in matters of authorisation and supervision of financial giants.

It is suggested that the US should take the initiative. It is currently home to the largest number of GSIBs by far. It also has the financial credibility to commit to the necessary guarantees, and—maybe most importantly—it has the factual power required to force both its GSIBs and their host nations in line. Once the US takes the lead, it is to be hoped that other home nations will follow its example. It would also end the currently pursued policies of US regulators to rely on unilateral action to ringfence their national financial market with little regard to international implications.

Concluding remarks

It is clearly a positive development that the national rules of bank regulation are following internationally aligned standards in all important financial centres around the world. This process achieves a high level of regulatory requirements for globally operating banks, thereby creating more resistance of these banks to stress. This leads to more stability of the individual institution and simultaneously to improved macroeconomic stability. It also helps regulators to better understand the requirements in other jurisdictions. Foreign banks are no longer black boxes headquartered in some distant jurisdiction where unknown principles of regulation are applied. This facilitates the supervision of foreign banks and communication among regulators and supervisors. It even leads to benefits for banks since unilateral national approaches generate high compliance costs for banks. Additionally, higher standards of bank regulation applied in all financial centres should improve confidence in the resilience of banks and lower their financing costs.

A global system is, however, incomplete until reliable commitments among home and host nations of GSIBs are in place. While a truly international regime with enforceable powers of international financial organisations and jurisdiction of international courts or tribunals seems currently still unrealisable, a more viable solution has been proposed here. All large exporters of systemic risk, i.e. the 11 home nations to the GSIBs named in the FSB list, should enter into binding agreements with all host nations of "their" GSIBs. These agreements should contain highly detailed commitments of home and host nations in GSIB rescue and resolution procedures. Dominant elements of these commitments should be, in accordance with the FSB key attributes, the lead responsibility of the home resolution authority and the principle of equal treatment of creditors (and, if existent, shareholders) in home and host jurisdictions. Financial burden sharing on either side should be determined in advance. If initiated by every home and joined by every host nation of GSIBs, these agreements would grow into a network spanning over the entire globe and connecting all jurisdictions in which GSIBs operate.

Regulatory competition would not be eliminated by such an approach, but rather guided in constructive ways. Depending upon home countries' commitments, host nations would see more or less incentives for ringfencing, and advantages or disadvantages for GSIBs would result from these developments, potentially influencing their decisions where to locate their headquarters.

Furthermore, all pre-arranged commitments must be fully reliable. Regulators can react to breaches of home nations by stepping up regulatory requirements for their GSIBs, and significant effects will follow when host nations co-ordinate such reactions. GSIBs will exercise their influence on their home jurisdictions when they experience negative consequences from compliance failures of their home regulators.

Such thought experiments cease to sound unrealistic when one looks at the recent regulatory developments in the US. The US has increased regulatory requirements for operations of foreign SIFIs. Initially voiced protests have faded, indicating that SIFIs and foreign regulators have accepted the lead role of the US. This lead role of the US should now be used to initiate the process of reliable commitments between host and home nations in the interest of global financial stability and under the premise of fair burden-sharing, thereby inducing other home nations of GSIBs to follow suit.