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The Athens Journal of Law

(ATINER)

Volume 5, Issue 4, October 2019

Articles

ATHENS INSTITUTE FOR EDUCATION AND RESEARCH
A World Association of Academics and Researchers
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The Athens Journal of Law
ISSN NUMBER: 2407-9685 - DOI: 10.30958/ajl
Volume 5, Issue 4, October 2019
Download the entire issue (PDF)

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Before you submit, please make sure your paper meets some basic academic standards, which include proper English. Some articles will be selected from the numerous papers that have been presented at the various annual international academic conferences organized by the different divisions and units of the Athens Institute for Education and Research.

The plethora of papers presented every year will enable the editorial board of each journal to select the best ones, and in so doing, to produce a quality academic journal. In addition to papers presented, ATINER encourages the independent submission of papers to be evaluated for publication.

The current issue of the Athens Journal of Law (AJL) is the fourth issue of the fifth volume (2019). The reader will notice some changes compared with the previous issues, which I hope is an improvement.

Gregory T. Papanikos, President
Athens Institute for Education and Research

Athens Institute for Education and Research
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13-16 July 2020, Athens, Greece

The Law Unit of ATINER, will hold its **17th Annual International Conference on Law, 13-16 July 2020, Athens Greece** sponsored by the Athens Journal of Law. The aim of the conference is to bring together academics and researchers from all areas of law and other related disciplines. You may participate as panel organizer, presenter of one paper, chair a session or observer. Please submit a proposal using the form available (https://www.atiner.gr/2020/FORM-LAW.doc).

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Important Dates

- Abstract Submission: **9 December 2019**
- Acceptance of Abstract: 4 Weeks after Submission
- Submission of Paper: **15 June 2020**

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4-7 May 2020, Athens, Greece

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Important Dates

- Abstract Submission: **1 October 2019**
- Acceptance of Abstract: 4 Weeks after Submission
- Submission of Paper: **6 April 2020**

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- **Dr. Gregory T. Papanikos**, President, ATINER.
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Addressing Duty of Loyalty Parameters in Partnership Agreements: The More is More Approach

By Thomas P. Corbin Jr.[*]

In drafting a partnership agreement, a clause addressing duty of loyalty issues is a necessity for modern partnerships operating under limited or general partnership laws. In fact, the entire point of forming a limited partnership is the recognition of the limited involvement of one of the partners or perhaps more appropriate, the extra-curricular enterprises of each of the partners. In modern operations, it is becoming more common for individuals to be involved in multiple business entities and as such, conflict of interests and breaches of the traditional and basic rules on duty of loyalty such as those owed by one partner to another can be nuanced and situational. This may include but not be limited to affiliated or self-interested transactions. State statutes and case law reaffirm the rule that the duty of loyalty from one partner to another cannot be negotiated completely away however, the point of this construct is to elaborate on best practices of attorneys in the drafting of general and limited partnership agreements. In those agreements a complete review of partners extra-partnership endeavours need to be reviewed and then clarified for the protection of all partners. Liabilities remain enforced but the parameters of what those liabilities are would lead to better constructed partnership agreements for the operation of the partnership and the welfare of the partners. This review and documentation by counsel drafting general and limited partnership agreements are now of paramount significance.

Keywords: *Partnership Formation, Duty of Loyalty; Partnership Agreements; Client Counselling.*

Introduction: General Rule on Duty of Loyalty in General/Limited Partnerships

The general rule regarding the fiduciary duty of loyalty in a partnership is that the partners are to put the success and interests of the partnership above their own personal and other business interests. Partners are considered both "a principal and an agent, both a trustee and a beneficiary"[1] with regards to the property, operation, benefits and obligations of the partnership. These concepts are nothing new but the modern operations of business and the law governing situation where partners are engaged in multiple business activities within and outside of the business entity are growing in consideration. Partners should avoid conflict of interests between their partnership duties and activities and their own personal and extra-curricular business activities, including but not limited to other business entities and personal activities. As a part of the duty

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[1]Crane & Bromberg (1968) at 389.

of loyalty, a partner must hold the partnership's property in trust for the benefit of all the partners and not use the partnership property for personal or non-partnership advantage.

> "For example, a general partnership may own an office building, but a general partner should not dispose of that partnership asset for his or her individual economic gain to the detriment of the partnership. In some instances, you may be allowed to obtain an individual benefit from partnership assets after full disclosure to and prior approval from the other partners."[2]

Generally speaking, a partner's fiduciary duties may not be waived or eliminated in partnership agreements and in fulfilling those fiduciary duties, each partner must act consistently with the obligations of good faith and fair dealing.[3] "Good Faith" and "Fair Dealing" has been defined by courts as covenants owed to each partners by the other and further considered as "the person undertaking an action must believe that the determinations or other action is in the best interests of the partnership;" and "consistency with the parties' agreement and its purpose", respectively.[4]

It should also be noted that partners are permitted to pursue their own non-partnership related interests without automatically violating their fiduciary duties.[5] The most important aspect in determining if there was a breach of the duty of loyalty is a question of disclosure to other partners. However, in *Dieckman v. Regency*, a 2017 decision, [6] the Delaware Court of Chancery decided to "again confirmed that the contractual arrangements set forth in a limited partnership agreement will define the respective rights and obligations of the partners, including with respect to the general partner's fiduciary duties (and related duty of disclosure) in connection with affiliated transactions."[7] In limited partnerships, some jurisdictions, such as Delaware, have allowed for the parties to "expand or restrict fiduciary duties," but "they could not fully eliminate them."[8] Of course, this only becomes of large concern when limited partners take either a managerial or controlling stake in the partnership.[9] It would also be of potential concern where the limited or silent partner's contributions are such that they overshadow every decision made by the day-to-day operators and the general partners.

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[2]Fiduciary Duties in Partnerships, NOLO Legal Encyclopedia, Legal Topics, Business Formations.
[3]See generally, Uniform Partnership Act, 103(b) and 404(d).
[4]Reid (2014), *Allen v. El Paso Pipeline GP Co.*, L.L.C., C.A. No. 7520-VCL (Del. Ch. May 19 2014) (Laster, V.C.) and *Feeley v. NHAOCG*, LLC, 62 A.3d 649, 664 (Del. Ch. 2012) (citing Arnold v. Soc'y for Savs. Bancorp, Inc. 678 A.2d 533, 541–42 (Del. 1996).
[5]Uniform Partnership Act, 404(e).
[6]*Diechman v. Regency, GP LP*, et al., No. 208, 2016 (Del. Jan. 20, 2017)
[7]Fried Frank (2016).
[8]See *Gotham Partners, L.P. v. Hallwood Realty Partners, L.P.*, 817 A.2d 160, 167 (Del. 2002) and Lewis (2013).
[9]Fiduciary Duties in Partnerships, NOLO Legal Encyclopedia, Legal Topics, Business Formations.

Analysis of State Partnership Acts in Comparison to the Standard Uniform Partnership Act and the Revised Uniform Partnership Act

The term duty of loyalty has scant appearance in the Uniformed Partnership Act and an understanding of what can be "interpreted" as duties of loyalty can be found in a "number" of places in the Uniformed Partnership Act.[10] This can be contrasted, for example, with the Maryland Revised Uniform Partnership Act Subtitle 4[11] where it clearly outlines the Duty of Loyalty as

> "A partner's duty of loyalty to the partnership and the other partners is limited to the following:
> To Account to the partnership and hold as trustee for it any property, profit or benefit derived by the partner in the conduct and winding up of the partnership or derived from the use by the partner or partnership property, including appropriation of a partnership opportunity;
> (1) To refrain from dealing with the partnership in the conduct or winding up of the partnership business as or on behalf of a party having an interest adverse to the partnership; and
>
> (2) To refrain from competing with the partnership in the conduct of the partnership business before the dissolution of the partnership."[12]

As always, the election of where to file business operation paperwork is a strategic concern for parties, but a significant concern for the counselling clients in these regards should be considered. Protection of the client's well-being and interests in forming a business entity should be examined from the broad construct of avoiding as many potential hazards as possible. As such addressing duty of loyalty issues in a limited or general partnership would need to consider the statutory and case law review of the concept. Projections of potential hazards would then be paired within these confines to produce a protective arrangement leading to fruitful operations in the future.

The Michigan's Uniform Partnership Act,[13] like other jurisdictions, borrows heavily from model language but does not directly comment too greatly on what would constitute a duty of loyalty breach for partners within the partnership. In a General Partnership, also known in Michigan as a "Copartnership",[14] partners owe duties to one another as agents[15] and fiduciaries.[16] As such, agents acting outside of their stated duties or failing to hold in trust benefits derived to the partnership

[10]Weidner & Larson (1993). Also see generally Uniform Partnership Act § 18.
[11]Maryland Code: Corporations and Associations, Title 9A-Maryland Revised Uniform Partnership Act Subtitle 4-Relations of partners to Each Other and to Partnership, Section 404-General Standards of Partner's Conduct. (2010).
[12]Weidner & Larson (1993).
[13]Michigan Uniform Partnership Act 72 of 1917, Section 449.18-23.
[14]Frances.
[15]Michigan Uniform Partnership Act 72 of 1917, Sections 449.4(3) and 449.9.
[16]Michigan Uniform Partnership Act 72 of 1917, Section 449.21.

and all the partners is cause for dissolution by court decree.[17] Keeping this mind, from a client-counseling scenario, an attorney would in aiding in the original formation of a partnership, and purposefully drafting a general partnership agreement, would need to take time to explain agency and fiduciary concepts to the clients and potential partners. What would ultimately need to also be undertaken is clearly exploring with the clients any potential situation where a copartner[18] would have potential conflicts of interest including but not limited to self-dealing transactions or duty of loyalty breaches listed and documented clearly in the aforementioned partnership agreement.

What becomes notable at this juncture, is where a general partnership ends and a limited partnership begins. The Michigan Revised Uniform Limited Partnership Act provides for limited partnerships in the jurisdiction of Michigan.[19] Limited partners generally do not owe fiduciary duties, but they assume fiduciary duties if they take an active role in the management of the partnership.[20] What gives pause is what would constitute an active role in the management of the partnership and whether an issue of a self-interested transaction or an encouragement to have the partnership to conduct business with the limited partners' other business enterprises constitute an "active role" in the partnership management? General rules, including those in Michigan and Delaware,[21] all indicate that limited partners have not liability beyond their investment. In a perfect environment, limited partners in a LLP would have no say or "control"[22] on the day-to day operations of the partnership. However, this might not usually be the case when and where a limited partners takes an interest or in instances where the financial contribution to the enterprise is of such a size and shape that it would be a specter resting over all decisions being made by the general partners.

The fiduciary duty of loyalty is an important construct in the formation, operation and ultimately disassociation of a partnership. The Michigan Supreme Court has defined a fiduciary relationship as "a relationship in which one person is under a duty to act for the benefit of the other on matters within the scope of the relationship." As pointed out in Banker & Brisebais Co v John C. Maddox, CPA, unpublished opinion per curiam of the Michigan Court of Appeals, issued April 29, 2014 (Docket No. 310993):

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[17]See Michigan Uniform Partnership Act 72 of 1917, Sections 449.29-44 generally and Section 449.32(1)(d) & (f) which specifically states with regards to court ordered dissolution that: "A partner willfully or persistently commits a breach of the partnership agreement, or otherwise so conducts himself in a manner relating to the partnership business that it is not reasonably practicable to carry on the business in the partnership with him" and "Other circumstances render a dissolution equitable."

[18]Michigan Uniform Partnership Act 72 of 1917, Section 449.18-23.

[19]Michigan Revised Uniform Limited Partnership Act 213 of 1982, Section 449.1403.

[20]Feeley v. NHAOCG, LLC, 62 A.3d 649, 662 (Del. Ch. 2012) (citing Cantor Fitzgerald, L.P. v. Cantor, No. 16297, 2000 WL 307370, at *22 (Del. Ch. Mar. 13, 2000).

[21]Michigan Revised Uniform Limited Partnership Act 213 of 1982, Section 449.1403.

[22]See, e.g., BSA Mull, No. 310989, at *10 (applying Michigan shareholder oppression law to assist the court in understanding the LLCA's definition of "willfully unfair and oppressive conduct.") *See also* Mantese & Williamson (2014).

> "Fiduciary relationships arise (1) where one reposes trust in the faithful integrity of another, who gains influence over that person; (2) where one assumes control and responsibility over another; (3) where one has a duty to act for or advise another on matters within the scope of the relationship; and (4) when the specific relationship has traditionally been recognized as involving fiduciary duties, such as between lawyer and client."[23]

Legal constructs have allowed for a limiting of loyalty liability in limited liability partnerships and limited partnerships. Strong counseling on the issue would need to be a priority for attorneys aiding in the formation of a partnership agreement. Especially if the attorney is counseling the potential general partner in a limited partnership arrangement. Limited partners may have only given an infusion of cash to the partnership enterprise and assumed no day-to-day management or decision-making prowess. In those instances a firm argument of limits on duty of liabilities relevant. But again, in many cases the limited or silent partner's infusion of cash or buy-in to the partnership maybe of such a large sum, that the general partner maybe inclined to take decision making on management issues to the silent partner or even completely decide against proper actions due to fear of upsetting the silent partner. This might then result in a withdraw of the sum buy-in. It can thus be argued that first, a silent or limited partners may not have a defined duty of loyalty to a partnership but their influence may not be denied. Secondly, based on this influence, the level of control or the specter of control could influence the decision making of the partnership towards decision that may not be in the best interest of the other partners. This reality is not necessarily always present or even something that the legislature has any business manipulating. The freedom to contract is forever sacrosanct.[24] Also, the formation of a partnership is at its very nature a contractual agreement between the partners.[25] As such the parties are free to contract for and contract away whatever rights and liabilities they have in their partnership agreement. In his 2004 Suffolk Law Review Article, Professor Ribstein argues that that the "ULPA 2001 restrictions on contracting regarding fiduciary duties are seriously misguided because they are based on a fundamental misunderstanding of the special nature and functions of the limited partnership form".[26] A greater analysis of the logic and reasoning follows in the article, but the overarching reality is true that the freedom of contracting in partnership agreements should be rarely narrowed by legislation, however attorneys counseling clients should have a free range to limit partners, both general and limited in their drafting of the partnership agreement. Government has no duty or right to second-guess the decisions made by the contracting parties short of capacity deficiencies, legal requirements or instances of unconscionability. The larger point however, is that in the protection of the client's rights, an attorney in counseling the formation of the partnership

[23]Mantese & Willaimson (2014) quoting from Banker & Brisebais Co., v. John v. Maddo, CPA, unpublished opinion per curium of the Court of Appeals, issued April 29, 2014 (Docket No. 310993) "accountant-client relationship is not a traditionally recognized fiduciary relationship".
[24]Bernstein (2008).
[25]Mayer, Warner, Siedel, Lieberman & Martina (2012).
[26]Ribstein (2004).

agreement needs to advise the parties about potential conflict of interests or potential issues that may arise among the parties. In the case of silent or limited partners, general partners would need to clearly understand what limited partners may be able to engage in any and all extra-curricular activity that may be converse to the general partnership. Also, the general partners would need to be advised to always place themselves in a position where their decision making would never be compromised by the weight of the silent partners contribution to the enterprise or their conduct outside of the partnership confines. Strong counseling on potential conflict issues would act as a counter weight against the necessary but still problematic gaps in protecting general partners from the limited responsibility of limited or silent partners.

Partnership Agreements

Partnership agreements are one of the most underrated forms of risk management and avoidance in business operations. General partnership agreement often include language on basic structure, capital contributions, sharing of profits, management and control, accounting controls, dissociation and dissolution agreements and arbitration of disputes of any of the above.[27] In the formation of a partnership agreement, it is a reality that the human condition is forever present. Most likely, the constructing of a partnership in the beginning stages is one where the full range of cooperation, support and promotion of each of the partners is in play. All the partners likely operate under the belief that the other partner is as committed as they are and their expectations of the enterprise and the cooperating partners have only the upside in sight. But reality usually sets in after operation begins. Rarely do things work out as well as people's expectations. A cool and dispassionate viewpoint would best serve the enterprise in reviewing the intent, capabilities and contributing factors of the parties and then documenting them into a partnership agreement. As mentioned above, a complete and forethought focused partnership agreement would go a long way towards protecting clients in the formation, operation and if necessary dissociation events of a partnership if they included a concise language on fiduciary duties. It is well established that a partner cannot compete against his partnership, nor accept secret profits unless he obtains permission from the other partners.[28] Partnership formation agreements very often define exactly what conduct would constitute competition against the environment. The Revised Partnership Act, for example, indicates that one cannot

> "eliminate the duty of loyalty under Section 404(b) or 603(b)(3), but: (i) the partnership agreement may identify specific types or categories of activities that do not violate the duty of loyalty, if not manifestly unreasonable […]"[29]

[27]Clarkson, Miller & Cross (2015).
[28]Mallor, Barnes, Langvardt, Prenkert & McCrory (2016) at 1034.
[29]See Ribstein (2004) at fn. 4 discussing the Revised Partnership Act.

Consider for example, an agreement concerning a partnership of an auditing firm may point out that no partner may provide, including pro bono, auditing services except on behalf of the organised partnership.[30] This clause or agreement in a partnership agreement is not unlike non-competition clauses in employment contracts. The general rule of non-competition among general partners is rather simple to understand and enforce. What is more problematic and thus significant for the counselling of clients planning to be a general partner interested in taking on limited or silent partners is that limited partner do not owe a fiduciary duty to the limited partnership or the other partners in solely being a limited partner. As such a limited partner can invest in an auditing partnership, as exampled above, but then also invest in the across town rival with little to no recourse for the original partnership that was invested in. Limited partners are expected to hold the standard of good faith and fair dealing with a limited partnership and as such are expected to disclose significant issues that may impact the partnership.[31] But because many jurisdictions do not require much, if any agreement to be filed,[32] the formation of a general partnership is simply a matter of intent between the parties. In a Limited Partnership, the creation of the partnership must be created "only by complying with applicable state statute".[33] Without the protections of a partnership agreement partners often enter the enterprises with the best of intentions but without fully realizing the potential pitfalls. There are endless instances where the human condition can lead to ruin between partners but a thorough partnership agreement, signed and executed between the partners can minimize many of the area of potential discontent. With regards to the duty of loyalty issues, relying on the general rule as stated above and not fully documenting existing and recognised conflicts of interest that might arise due to extra-partnership activities by the partners themselves. From a legal counselling standpoint, attorneys would be hard-pressed to not suggest a partnership agreement between the parties but including provisions in an agreement fully underlining potential conflicts of interest and how the parties can recognise and avoid the conflicts is simple best practices for client management. A rigorous interviewing of potential general partners and potential limited partners with regards to their expectations of the partnership, the other partners and the knowledge of what the other partners' extra partnership activities is an essential part of drafting process. No stone, proverbial or otherwise, should be left unturned in determining what real, potential or possible conflict of interest or duty of loyalty breaches may arise in the operation of the partnership. Again, it should be stressed that duty of loyalty cannot be out right negated through a partnership agreement. However, a clear outlining of what the partners would see as a duty of loyalty issue between them should be fully outlined and be instituted into the agreement and used as a guideline through the business' operations and then also as a tool for

[30]Ribstein (2004).
[31]Ribstein (2004) at 1082.
[32]Frances, and See also Michigan Uniform Partnership Act 72 of 1917 Section 449.7.
[33]Ribstein (2004) at 1078. See also Uniform Partnership Act, last revised 2001.

avoidance of litigation in the future. Consider finally that decisions such as the Dieckman v. Regency decision indicates that

> "partnership agreements can eliminate all general partner fiduciary duties with respect to affiliated transactions."[34].

Understanding this then re-underlines the need of attorneys in client counselling to tell make sure the clients understand that there may be instances of potential conflict of interest. Documenting them ahead of time allows for the client to prepare for them and ultimately factor these possibilities into whether going into a partnership with a potential general or limited partner is worth the risk of having their actions harm the partnership or the other partners.

Practice Points and Sample Language for Duty of Loyalty Clause in Partnership Agreement

Some sample partnership agreements already include a Duty of Loyalty clause.[35] It is also noted that agreements can specify acts that the partners agree will violate a fiduciary duty and the key remains simply whether the partner, in the pursuit of their non-partnership endeavours, discloses to other partners the actions or conduct. But leaving too much discretion up to the "good conduct" or "faith based"[36] approach of the partners is problematic and best practices of attorneys should be to create for clients and more sturdy partnership agreement that constitutes potential duty of loyalty breaches. As noted above, RUPA[37] does indicate that partners cannot "eliminate the duty of loyalty, although the partners may identify specific types or categories of activities that do not violate the duty, if not manifestly unreasonable". It is the second part[38] of that statement, regarding the identification of types or categories of activities that attorneys in their counselling of clients and the drafting of partnership agreements need to take a strong review of in modern partnership formation and performance. This again, is due to the nature of the modern trend of partners being involved in a multitude of enterprises.

Successful general partnership agreements will need to take into the account and address any, and all extra-partnership endeavours that may endanger the partnership and limited partnership agreements should take care with regards to the extent to which general partners obligations are being restricted and how this would affect limited partners. Such provisions would include attention to the elimination of fiduciary duties, so called "safe harbour provisions"[39] for affiliated transactions, dispute resolutions of potential affiliated transactions such as a conflicts committee and the limits of the disclosure obligations.

[34]Fried Frank (2016).
[35]Law Depot, Free Partnership Agreement, Create Your Partnership Agreement-Place of Business: Michigan.
[36]See generally, Uniform Partnership Act, 103(b) and 404(d).
[37]Uniform Partnership Act, Section 103(a).
[38]Weidner & Larson (1993).
[39]Fried Frank (2016).

An aggressive pursuit of understanding all of the potential partners' interests in the formation or addition to a general or limited partnership is the best tactical advice for attorneys aiding in the drafting of partnership agreements. Asking the hard questions and presenting the difficult 'what if' situations to the partners is part-and-parcel of zealous representation. If an attorney sees a potential conflict of interest, self-dealing issue or any other duty of loyalty breach, the attorney will need to bring it to the client's attention. Once discussed, the clients can decide how to minimize the potential impact of the duty of loyalty issue and then document it a partnership agreement. This foresight will also make the management of the general or limited partnership more manageable as well. Known expectations are always more manageable than unknown variables.[40]

Even understanding the basic rule that limited partners are not held to the same level of fiduciary duty[41] as general partners, it behoves an advising attorney to flush out completely any and all potential issues that may arise. Though it is true that the limited partner may not ultimately be held liable or responsible in a potential duty of loyalty claim, a general partner should be fully advised as to this reality and protected against to the fullest extent in the partnership agreement. This can only be accomplished by ferreting out the potential issues through aggressive questioning of the potential partners about their current and future activities. Undoubtable, as partnerships are subject to the constant human condition of expectations being high in the beginning may create a chilling effect on formation as realization about traits and expectations of other partners come into full view. It can be recommended that a partnership clause, created after a full and frank conversation with potential partners, be included in a formation or limited partnership agreement/addendum. Language in that clause should include notation of relevant and recognised conflict of interest issues at the onset and then mechanisms to deal with any unforeseen conflicts that would arise later. A simple, yet sample clause could read as follows:

> "General Partners are held to any and all statutory duty of loyalty issues as they pertain to the operation of the partnership. All known conflict of interest issues must be detailed at the formation of the partnership and it is the duty of any and all potential partners to fully disclose their conflicts to the other partners so that a fully and complete waiver, if so chosen, can be made in a fully informed manner.
> Concerning future partners, either limited or general, that chose to join the partnership would be under an affirmative obligation to disclose any and all potential conflicts prior to joining the partnership.
> If future conflicts of interest arise in conduct or the pursuit of the partnership enterprise the partners would be under an affirmative duty to disclose the conflict of interest at the earliest moment to allow for the other partners to react and make informed decisions on the manner.
> In the case of limited partners, it is understood by all partners, general and otherwise that limited partners are not held to the same level of fiduciary responsibility as general partners, however in the maintenance and continuation of this partnership

[40]Courtney, Kirkland & Viguerie (1997).
[41]*Feeley v. NHAOCG, LLC,* 62 A.3d 649, 662 (Del. Ch. 2012) (citing Cantor Fitzgerald, L.P. v. Cantor, No. 16297, 2000 WL 307370, at *22 (Del. Ch. Mar. 13, 2000) and Ribstein (2004).

enterprise it would be prudent for all partners to know of potential conflicts and be allowed to make a fully informed decision as to the admittance or contribution of the limited partner."

Conclusion

The bottom line for counselling clients in their formation or involvement in a general or limited partnership is to making sure their interests are protected and fully documented. Counselling clients includes managing expectations and being able to clearly see potential issues that clients would not see as they may be blinded by altruism, false faith or unreasonable expectations. As stated above the creating of partnership agreement is helpful in minimizing and managing risk for the partners. Within that agreement, a clause specifically dealing with duty of loyalty issues needs special attention. In modern business operations it is becoming common place for partners to have several business enterprises and as such those enterprises pose the risk of conflicting with the operation and promotion of each other. Additionally, partners are increasingly interested in limiting liability and responsibility while also maximizing their options. This reality creates the perfect environment for potential duty of loyalty transgressions. Common happenstance duty of loyalty issues such as self-interested transactions, competing interests and others will be at issue the more compound and complex the interests of the individual partners' extra-curricular activities are at play. It should be re-underlined that the power of parties to contract freely should not be impeded or second-guessed by courts, the legislature or the model provisions such as the Revised Uniform Partnership Act.[42] To do so would cause a chilling effect and "trade and commerce could not thrive if freely made agreements were not normally carried out".[43] Additionally the need for trial and error in the contracting and partnership agreements lead to a stronger and more educated plans of action in the future.[44] But it is exactly that philosophy that would encourage legal practitioners to push potential partnership seekers towards complete disclosure and understanding on potential hazards that may arise in the future. As stated above fiduciary duties such as loyalty and care cannot be fully eliminated but may be regulated by agreement, especially in limited partnerships.[45] But understanding what a partner may or may not do in the future may also save the other partner the headache of associating with the potential hazard in the first place.

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[42]See Ribstein (2004).
[43]Younkins (2000). See also Postrel (1999).
[44]Weidner & Larson (1993).
[45]Lewis (2013).

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The Debt Ratings Debate and China's Emerging Credit Rating Industry: Regulatory Issues and Practices

By Jin Sheng[*]

Credit Rating Agencies (CRAs) have been regarded as one of the industries which are account for the global economic downturn. The "Debt Ratings Debate" after the subprime crisis of 2007 discussed the effectiveness of the credit rating system and raised questions in practice. Accompanying the boom and deregulation of the bond market over the last decade, China's emerging credit rating industry has entered a stage of rapid growth. This paper seeks to review legal issues of China's credit rating agencies (CRAs) from the perspective of comparative study. Part I gives an overview of two main stages in the development of this emerging industry. Part II and Part III examine major issues in the debt ratings debate, such as conflict of interests, enhancing competition and regulatory reform. Part II first compares the advantages and disadvantages of various pay models for CRAs, including the dominant issuer pays model and alternative pay models; then it discusses how regulation affects competition and business activities of credit rating agencies and related regulatory reform in the U.S. and EU. Part III examines the barriers, and cause of action concerning the CRA liability through some significant cases, such as County of Orange v. McGraw Hill Cos, Jefferson Cty. Sch. Dist. No. R-1 v. Moody's Investors, Inc., and Abu Dhabi Comm. Bank v. Morgan Stanley & Co.in the U.S. Part IV reviews the practices of four major Chinese CRAs. Part V examines the multiple regulatory system and two self-regulatory organizations for credit rating industry. Part VI discusses a series of legal issues in the Chinese context, such as the current issuer pays model and conflicts of interest, reputational mechanism, rating shopping, market access, independence of CRAs and accountability of credit rating agencies, as well as a recent case concerning the credit rating of a peer-to-peer lending platform. Finally, it concludes that the financial system reform and forthcoming structure reform may change the multi-regulator system.

Keywords: *Credit Rating Agency (CRA); Issuer Pays Model; Investor Pays Model; Rating Shopping; CRA Liability*

Introduction: China's Emerging Credit Rating Industry

The emergence of China's credit rating industry has experienced a few stages. The earliest stage developed slowly. In February 1988, Shanghai Fareast Credit Rating Co., Ltd. was founded as the first credit rating agency with the approval of the PBoC Shanghai Branch.[1] The State Economic and Trade Commission and PBoC approved the establishment of China Chengxin and Dagong Global in 1992

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[1]Dagong Global, "The Brief History of China's Credit Rating Industry", http://en.dagongcredit.com

and 1994 respectively. In 1997, the PBoC accredited nine CRAs the qualification of national credit ratings.[2] In 1999, China Chengxin International Credit Rating Co., Ltd. became the first joint-venture CRA in China. In the 1990s, a few CRAs such as the China Lianhe Credit Rating Co., Ltd., China Chengxin International Credit Rating Co. Ltd., Dagong Global Credit Rating Co., Ltd., Shanghai Brilliance Credit Rating & Investors Service Co., Ltd., and Pengyuan Credit Rating Co., Ltd. were founded. After 2005, their business made substantial progress accompanying the boom and deregulation of bond markets. In January 2019, S&P became the first foreign CRA to be permitted to provide credit rating services via a wholly own company in China.[3] China promised to open the market for foreign CRAs in two years. On July 20, 2019, the State Council's Financial Stability and Development Committee issued "Relevant Measures Concerning Further Expansion of External Opening of the Financial Sector", allowing foreign CRAs to rate all types of bonds.

Early Stage of Credit Rating Industry and Segmented Bond Markets

The growth of China's credit rating industry keeps pace with the development of China's bond market. In March 1987, the State Council enacted the *Interim Regulation on Administration of Enterprise Bonds*, which established the issuance and administration system for state-owned enterprises (SOEs) to issue enterprise bonds. The 1987 regulation stipulates that People's Bank of China (PBoC), Ministry of Finance (MOF) and the State Planning Office shall work out the annual quota of enterprise bond issues on a national scale and proceed at the province level.[4] In 1993, the State Council enacted the *Regulation on Administration of Enterprise Bonds* to promote the enterprise bond market. The 1993 Regulation solidified the approval system and the PBoC, MOF, State Planning Office and the State Council Securities Commission formulated the inaugural annual quota for issuing enterprise bonds.[5]

The allocation system for approved bond issues decided by the State Council in 1992 is as follows: (a) The Ministry of Finance is in charge of government bonds; (b) The PBoC approves financial bonds and investment securities bonds; (c) The State Planning Office approves state investment bonds and state investment corporate bonds; (d) The PBoC and the State Planning Office approve central state-owned enterprise bonds; (e) Local government bonds are approved by the provincial governments or governments of cities specifically designated in the state plan.[6]The framework of separate operation and separate regulatory system produced the following two bond markets:

[2]Circular of PBoC *Yin Fa* [1997] No. 547.
[3]S&P Global (2019).
[4]Article 12 of the *Interim Regulations on Administration of Enterprise Bonds* issued by the State Council on March 27, 1987 and replaced by the *Regulations on Administration of Enterprise Bonds* on August 2, 1993.
[5]Articles 10 and 11 of the *Regulations on Administration of Enterprise Bonds* issued by the State Council on August 2, 1993 and amended on January 8, 2011.
[6]Article 2.2 of the *Notification on Further Strengthening Macro-economic Management of Securities Market* issued by the State Council on December 17, 1992.

	Inter-bank Bond Market	**Exchange Bond Market**
Market Participants	Commercial banks are the major market player; Other participants include non-bank financial institutions, enterprises and public institutions. Not open to individual investors	Non-bank financial institutions, non-financial institutions and individual investors.
Traded Bonds	Government bonds; Enterprise bonds;[7] Policy financial bonds; Central bank bills;[8] commercial paper;[9] Medium-term notes[10]	Government bonds; Enterprise bonds; Corporate bonds[11]
Self-regulatory Organization	National Association of Financial Market Institutional Investors (NAFMII)	Securities Association of China (SAC)
Regulator	The People's Bank of China (PBoC)	China Securities Regulatory Commission
Yield Rate of Bonds	Relatively low yields	High yields
Liquidity	With higher market liquidity	With lower liquidity ratio

In the mid-1990s, enterprise bond default rates continuously rose. By the end of 1997 default risks piled up to nearly CNY 3 billion; in Liaoning Province and Jilin Province the default rate rose above 50%.[12] In 1998, the PBoC required that enterprises should provide guarantees when issuing bonds, except those approved by the PBoC for exemption.[13]

Meanwhile, the government took measures to solve the credit default problem. The issuers were required to provide commercial bank guarantees. In

[7]The issuance of enterprise bonds is approved by the NDRC. "Enterprise bonds" refer to "the negotiable securities issued by enterprises in accordance with legal procedures, and on which such enterprises agreed to pay principals and interests within a certain period." See Article 5 of the *Administrative Regulations on Enterprise Bonds* issued by the State Council on August 2, 1993 and amended in 2011.

[8]Central bank bills are issued based upon the *Interim Measures of the PBoC for the Administration of Financial Bills* (1993).

[9]"Commercial paper" refers to "the debt financing instrument agreed to repay principal and interest within one year issued by non-financial enterprises (hereinafter referred to as the enterprises) with legal person qualification in the inter-bank bond market". See Article 2 of the *Guidelines by NAFMII (15 April 2008).*

[10]"Medium-term notes" refer to "debt financing instruments agreed to repay principal and interest in a certain term issued by phases according to the plan by non-financial enterprises (hereinafter referred to as the enterprises) with legal person qualification in the inter-bank bond market". See Article 2 of the *Guidelines by NAFMII (16 April, 2008).*

[11]The issuance of corporate bonds is approved by the CSRC. "Corporate bonds" refer to "marketable securities issued by a company pursuant to statutory procedures whose principal plus interest shall be serviced within a specific time limit as agreed upon". See Article 153 of the *PRC Company Law* (2014 amendment).

[12]Tao (2014).

[13]Article 3 of the *Administration of Issuance and Transfer of Enterprise Bonds* issued by PBoC on April 1, 1998 and nullified on August 17, 2000.

June 2004, the PBoC issued a regulation directing towards the inter-bank bond market. This allowed commercial banks to hold subordinated bonds issued by other banks capped at 20% of their core capital.[14] In 2003, the NDRC took the place of the State Development and Planning Committee[15] in the administration of enterprise bond issues. As a result of the strict approval system and "rigid redemption", the default risk from 1998 to 2006 dropped to a more acceptably low rate.[16] From 2001 to 2004, Chinese CRAs only issued ratings for 60 bonds, whose issue volume was less than CNY 150 billion.[17] Therefore, during that timeframe there was a limited market for credit ratings.

Rapid Development after 2005

The year of 2005 is an important turning point for both the Chinese credit rating industry and bond market. The turning point occurred when the NDRC decided to boost the enterprise bond market. Later, the emergence and rapid development of Subordinated debts of Commercial banks, non-policy financial bonds, commercial paper, asset-backed securities and medium-term notes, greatly boosted the inter-bank bond market and the exchange market, thus promoting a continued progression of the credit rating industry.

In May 2005, the PBoC allowed qualified financial institutions to underwrite and/or trade short-term financing bonds in the National Inter-bank Bond Market under an agreement.[18] In 2005, 79 short-term financing bonds were issued and the volume reached CNY 142.4 billion. From 2005 to 2012, the emergence of a large number of short-term financial bonds, commercial paper and medium-term notes (MTNs) promoted the credit rating industry; Chinese CRAs issued ratings for 6,155 bonds, of which short-term financial bonds and medium-term notes occupied 62.15%.[19]

In 2008, the NDRC enacted NDRC Finance [2008] No. 7, which allowed enterprises to issue unsecured bonds, asset-backed bonds and third-party secured bonds.[20] Considering the risk of off-balance sheet manipulation, the CBRC required commercial banks to gradually withdraw from project-based enterprise bond issue guarantees while simultaneously eliminating their ability to provide guarantees on new bond issues. After 2008, the NDRC no longer required financial guarantee for enterprise bond issues. Thereafter, the proportion of

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[14] Article 13 of the *Rules on the Issuance of Subordinated Bonds by Commercial Banks* issued by PBoC on June 17, 2004.

[15] The State Planning Office became the State Development and Planning Commission in 1998 in the restructuring of the State Council. In the 2003 restructuring of the State Council, the National Development and Reform Commission (NDRC) took the place of the State Development and Planning Committee together with the previous State Economic Restructuring Office and part functions of the State Economic and Trade Commission.

[16] Lin (2005).

[17] Guo & Zhang (2012) at 14-19.

[18] Articles 2 and 3 of *Operating Procedures for the Underwriting of Short-term Financing Bonds* issued by the PBoC on May 23, 2005 and nullified on April 15, 2008.

[19] Guo & Zhang (2012) at 14-19.

[20] Article 3 of the *Notification on Promoting the Development of Enterprise Bond Market and Simplifying Related Items of Approval-based Issuance Procedure* issued by the NDRC on January 2, 2008.

secured bonds decreased year after year, declining from 19.4% in 2008 to less than 10% in 2013.[21]

In 2011, the Ministry of Finance initiated the pilot self-issue of bonds for local governments of Shanghai municipality, Zhejiang province, Guangdong province and Shenzhen city to implement in 2011, upon the approval of the State Council. The terms of 2011 government bonds were issued in three years and five year, subject to the issue scale approved by the State Council.[22] In 2013, the Ministry of Finance enlarged the scope of “Pilot Provinces (Municipalities)” to Shanghai Municipality, Zhejiang Province, Guangdong Province, Shenzhen City, Jiangsu Province and Shandong Province.[23] In 2019, China bond market has reached USD13 trillion. Yet, debt failures increase too.[24]

The booming bond market after 2005 stimulated the development of credit rating industry. Chinese CRAs sought to cooperate or establish joint ventures with the Big Three: Moody’s owns a 49% share in China ChengXin International Credit Rating Co., Ltd.; Fitch owns 49% of China Lianhe Credit Rating Co., Ltd.; Shanghai Brilliance Credit Rating & Investors Service Co., Ltd also has technical cooperation with Standard & Poor’s. The cooperation with the Big Three and the boom of bond market helped China‘s credit rating business enter a stage of stable development. By 2011, the market share of credit rating business among five CRAs in China’s inter-bank bond market and exchange bond market was as follows:[25]

	Dagong Global	**China Lianhe**	**Shanghai Brilliance**	**China Chengxin**	**Shenzhen Pengyuan**
CPs	17.05%	30.49%	10.66%	35.90%	0.00%
MTNs	22.12%	31.76%	16.00%	30.12%	0.00%
Enterprise Bonds	25.79%	17.89%	11.58%	18.42%	26.32%
C-Bonds	8.70%	22.83%	9.78%	44.57%	14.13%
Financial Bonds	12.12%	45.45%	6.06%	36.36%	0.00%
In Total	19.19%	28.96%	12.30%	32.22%	4.67%

Aside from domestic strategies, Chinese CRAs have pursued international-lization. In December 2003, Shanghai Far East Credit Co. Ltd. (SFECR) joined the ACRAA.[26] Later, five other Chinese CRAs, including China Chengxin, China Lianhe, Dagong Global, Shanghai Brilliance Rating, and Golden Credit Rating International Co., Ltd., have become members of the Association of Credit Rating Agencies in Asia (ACRAA).[27] As of August 13, 2015, four Chinese CRAs--Chengxin, Lianhe, Dagong Global (including Dagong Europe Credit Rating, S.r.l.

[21]Lin (2005).
[22]*Measures for Pilot Self-issue of Bonds by Local Government in 2011* issued by the Ministry of Finance.
[23]*Pilot Measures for Local Governments on Issuing Their Own Debts in 2013* issued by the Ministry of Finance on June 25, 2013.
[24]Bloomberg news (2019).
[25]Zhang (2013) at 76-80. These data are originally from WIND database.
[26]“Filing materials of the Shanghai Far East Credit Rating Co., Ltd.” (November 2005), www. chinabond.com.cn/Info/812702.
[27]ACRAA, http://acraa.com/acraamembers.asp.

in Italy), and Shanghai Credit Information Services Co., were recognised by the European Securities and Markets Authority (ESMA).[28]

With regard to credit information database, the PBoC Credit Reference Center (CCRC) was established in 2006 and then registered in Pudong New Area, Shanghai in 2008. In 2014, the Chinese government announced the plan to establish a social credit system covering financial, economic, and socio-political responsibility in line with China's social control.[29] In 2015, the Chinese government launched pilot programs in consumer credit reporting. Eight technology companies, including Alibaba's Sesame Credit, Tencent Credit, Ping An's Qianhai Credit, Kaola Credit (for P2P online lending), Pengyuan Credit, China Chengxin Credit, Qianhai Credit Service, and IntelliCredit, Sinoway Credit, participated in the pilot program and provided data and technology support. Thereafter, the PBoC realized the "credit leap forward" through collection of sharing eight firms' consumer data. As a result, the Baihang Credit—Chian's first unified personal credit information firm" was launched on March 23, 2018.[30] In 2019, CCRC has covered credit information of 990,000,000 individuals as well as 25.92 million enterprises and other entities.[31] It is noted that the CCRC system is a mixture of economic criteria and non-economic criteria and it can be used to punish offenders on the certain blacklists. This is a much broader range of usage of the social credit system compared with other countries which generally limits to financial measures of creditworthiness.[32]

The Debt Ratings Debate and Related Regulatory Reform on CRAs

Inadequate or incorrect ratings by the CRAs produced significant losses and were a substantial component of the 2008 global financial crisis. The "Debt Ratings Debate" mainly focuses on conflict of interest arising from the issuer pays model, reputational mechanism, accountability of credit ratings, and CRAs' liability of false ratings.

The Debt Ratings Debate

The debt ratings debate after the subprime crisis of 2007 discussed the effectiveness of the credit rating system and raised questions such as whether the failure of ratings had been "a result of a potential conflict of interest and/or a lack of competition in the industry".[33] The *Dodd-Frank Wall Street Reform and Consumer Protection Act*, covered CRA reform.[34] Due to significant conflicts of

[28]Wikirating (2015).
[29]*Notice of the People's Bank of China on Issuing the Industry Standards on Standards of User Management in Basic Financial Credit Information Database* issued on November 2, 2014.
[30]Koetse (2018).
[31]PBoC (2019).
[32]Mercator Institute for China Studies (2017).
[33] Henderson (2008).
[34]*Dodd-Frank Act*, Pub. L. No. 111–203, 124 Stat. 1872–90 (2010) (enacting "Subtitle C—Improvements to the Regulation of Credit Rating Agencies", §§ 931–939H of the Dodd-Frank bill).

interest that exist in the issuer pays model, alternative payment models were proposed for consideration as stated in the following table.

Pay Models	**Advantages**	**Disadvantages**
Issuer Pays Model Securities issuer pays the credit rating	Widely used since 1970s; Ensures ratings available to the entire bond market	Resulted in conflicts of interest; CRAs may compromise on profits at the cost of qualify of ratings
Investor Pays Model Investors or subscribers pay the credit rating	CRAs feel independent of issuers; Partly avoids problems of conflicts of interest;	Increases the cost of investment risked and thus reduces demand for securities; Reduces the independence of CRAs
"Payment-upon-Results" Model CRAs' payment depends on the accuracy of ratings	This model "could hold CRAs more accountable for the quality of their ratings".[35]	Hard to implement this model
Public Utility Model This model suggests to establish a government managed CRA[36]	Using the results of public CRA to check credit ratings issued by private CRAs	Concerns about expense; Increasing overreliance on rating results
"Trading venues Pay" Model A joint model for issuer pays model and investor pays model	This alternative accommodates both the issuer pays model and subscriber/investor pays model	Not covers large number of unlisted securities; Not favoured by market participants and public authorities
Hiring Agent Model A public or private utility or a SRO assigns NRSROs to determine the debt ratings.	This model tries to introduce a third-party agent to solve the problem of conflicts of interest	Concerns about costs; Hard to operate
Blind, Pooled Issuer-Pay Model This model requires issuers to pool the payments and let an independent third-party assign a CRA to rate the issuer's security.[37]	This model may solve problems of free rider, conflict of interest, and competition.[38]	Considering their limited number, CRAs may act as a whole and still favour issuers over investors in issuing ratings; May lead to more "homogenised".[39]

The debt ratings debate has highlighted that the role of CRAs going forward is far from certain. Despite all of the outcry over the problems plaguing CRAs, clear

[35]Garcia Alcubilla & Ruiz Del Pozo (2012) at 251.
[36]European Commission (2010).
[37]Senator Al Franken (D-Minn.), who introduced such a proposal as an amendment to the Senate version of the Dodd-Frank Act, called for the creation of a Credit Rating Agency Board to serve as a central clearinghouse for issuer's seeking ratings. He argued that this proposal eliminates many of the conflict of interest concerns.
[38]The *Dodd-Frank Wall Street Reform Act* requires the SEC to evaluate such a proposal, in conjunction with a Government Accountability Office study, and to accordingly enact regulations creating a Credit Rating Agency Board to serve as a central clearinghouse for issuer's seeking ratings, unless the study suggests alternative action. See *Dodd-Frank Wall Street Reform and Consumer Protection Act*, Pub. L. No. 111–203, 124 Stat. 1887–88 (2010) (§§ 939D–939F).
[39]Drawbaugh & Sullivan *(*2010).

solutions do not exist. There still do not appear to be any substantially viable solutions to resolving conflicts of interest that would not create additional problems or conflicts.

Post-crisis Ratings Reform in the United States

An examination of the existing regulations concerning the liability of CRAs makes it apparent that deregulation is an unlikely policy choice. Prior to the subprime crisis, CRAs were treated leniently. For example, CRAs are exempted from Regulation FD. Before 2009, Rule 436(g) exempted Nationally Recognised Statistical Ratings Organizations (NRSROs) from liability if they knowingly made false or misleading statements related to securities registration, although non-NRSRO CRAs were legally liable for their statements. On July 22, 2010, the *Dodd-Frank Act* nullified SEC Rule 436(g) and thus imposed Securities Act Section 11 liability on rating agencies. Section 939A of the *Dodd-Frank Act* requires all federal agencies, within one year of passage, to end regulatory agency reliance on credit ratings and replace such references with alternative criteria that evaluate the credit-worthiness of an issuance. In the wake of the *Dodd-Frank Act*'s changes, the SEC announced the end of the Regulation FD exemption for CRAs, which took effect on October 4, 2010.[40] However, as of March 16, 2011, members of the Capital Markets Subcommittee of the House Financial Services Committee introduced a few bills designed to repeal Section 939A of the *Dodd-Frank Act*.[41] As a result, whether and how to impose liability on CRAs for their ratings is debatable.

Regulatory Reform in the European Union

In Europe, the European Commission's *Public Consultation on Credit Rating Agencies* examined the overreliance on external credit ratings, enhancing competition in the credit rating industry, potential conflicts of interest arising from the "issuer-pays" model, and the civil liability of CRAs.[42] EC 1008/2009 addresses the independence and integrity of CRAs (long-lasting relationships between CRAs and rated entities). For example, Article 6a "Conflicts of Interest Concerning Investing in CRAs" requires a shareholder or a member of a CRA holding at least 5% shares or voting right in that CRA or in a company which has control rights over that CRA shall avoid conflict of interest under certain circumstances.[43]

In addition, Article 35a of EC 1008/2009 stipulates a CRA is liable for any intentional infringements or gross negligence listed in Annex III which has an impact on a credit rating.[44] The proof of evidence of an infringement is generally

[40]SEC Removal from Regulation FD of the Exemption for Credit Rating Agencies, 17 C.F.R. § 243 (2010).
[41]Kohl (2011).
[42]European Commission (2010).
[43]Article 6a Item 1 of the *Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on Credit Rating Agencies*.
[44]Title IIIA, Article 35a "Civil Liability", Item 1 of EC 1008/2009.

on the investor or issuer who claims for damages of the infringement from a CRA.[45]

IOSCO Code of Conduct for CRAs

The International Organization of Securities Commissions (IOSCO) issued *Principles Regarding the Activities of Credit Rating Agency* in September 2003 and *Code of Conduct Fundamentals for Credit Rating Agencies* in March 2015. The IOSCO CRA Principles propose four objectives for CRAs, regulators, rated entities and other market players: (i) quality and integrity of the credit rating process; (ii) independence and conflicts of interest; (iii) transparency and timeliness of ratings disclosure; (iv) confidential information.[46]

Type 10 of Financial Services License in Hong Kong

Under the CAP 571 Securities and Futures Ordinance, the Securities and Futures Commission (SFC) started to implement licensing of credit rating agencies and their rating analysts on June 1, 2011. The SFC issued license of Type 10 (providing credit rating services) to Moody's, S&P, Fitch, A.M. Best Asia-Pacific and CTRISKS in 2011. In June 2012, China Chengxin (Asia Pacific) Credit Ratings Company Limited obtained the license of providing credit rating services (Type 10) granted by the Securities and Futures Commission (SFC) in Hong Kong and became the first overseas CRA of Mainland China.[47]

CRA Liability: Perspective of Case Law

Arguments for and against CRA Liability

Prior to the 2008 crisis, NRSROs were generally immune from civil liability or compensation either for misrepresentation as an expert under Section 11 of the *1933 Securities Act* or for fraudulent liability under 10(b)-5 of the *1934 Exchange Act*. In those few lawsuits against CRAs, such as *Washington Pub. Power Supply System* (1983),[48] *Executive Life Bankruptcy* (1991),[49] *Jefferson Cty. Colo. Sch. Dist. v. Moody's* (1995),[50] and *Newby v. Enron Corp.* (2005),[51] plaintiffs failed in suing CRAs for professional negligence or fraud.[52] However, the aftermath of the subprime crisis greatly challenged the role of CRAs and thus triggered the debate over CRAs' liability.

[45]Ibid, Item 2.
[46]IOSCO (2003).
[47]China Chengxin (HK), www.ccxap.com.
[48]666 P.2d. 329 (1983).
[49]942 F.2d 1457 (9th Cir. 1991).
[50]988 F. Supp. 1341 (D.C. Colo. 1999).
[51]302 F.3d 295 (5th Cir. 2002).
[52]Partnoy (2009).

The disagreements focused on CRAs' role as either "toolmaker" or "gatekeeper", whether to apply fraud liability in "hostile ratings,"[53] and whether to establish corresponding conduct business rules as well. CRAs argue that they should be treated as "toolmakers" and stress credit ratings as a "predictive opinion" rather than an opinion of result.[54] The "gatekeeper" perspective subjects CRAs to liability for issuers' wrongdoing.[55] Additionally, CRAs regarded ratings ad predictive judgments, which are model-driven in the structured-finance context and the model methodology itself is subjective judgment.[56] Rule 436(g) exempted NRSROs from Section 11 liability for misstatements made in securities registration. In 2009, the SEC tried to rescind Rule 436(g). The final disagreement concerns imposing negligence liability, although CRAs historically rely on First Amendment defences to avoid the imposition of liability. In addition to the debate over whether to impose liability, the question of what standard to apply is also widely debated.[57]

Relating Cases in the United States

The issue of imposing liability on CRAs for their ratings concerns a wide arena of the law: professional negligence, breach of contract, misstatement, violation of antitrust laws, and securities fraud. A review of some significant cases gives an overview of the main issues, barriers, and causes of action concerning CRA liability.

County of Orange v. McGraw Hill Cos.[58]

In June 1996, Orange County brought a lawsuit for breach of contract and professional negligence against S&P. Orange County contended that S&P inflated its ratings of the County's notes and bonds in 1993 and 1994. Orange County, which suffered a huge financial loss of $5 billion from its risky investment in derivatives and high-yield bonds, filed for financial bankruptcy in December 1994. S&P, however, claimed that a CRA was protected by the First Amendment and exempted from professional negligence providing that S&P had no "actual malice" in overrating securities issued by the Orange County.[59] The "actual malice" standard, requiring "knowledge that the statement was false or with reckless disregard for whether or not it was true," was applied in this case.[60] Ultimately, the lawsuit was dismissed, and Orange County accepted a nominal sum of $140,000,

[53]In the context of CRA treatment, a "gatekeeper" refers to a CRA that is treated as an agent that serves as a check on the compliance of products within the securities market. "Toolmaker" status treats the CRA as an objective specialist in dealing with credit ratings. A "hostile rating" refers to a CRA rating that imposes negative effects on credit ratings.
[54]Deats (2010).
[55]Partnoy (2006).
[56]Hunt (2009).
[57]Ibid.
[58]245 B.R. 151 (C.D. Cal. 1999).
[59] Ibid.
[60]*Hustler Magazine v. Falwell*, 485 U.S. 46, 56 (1988).

which was equal to a partial refund of rating fees paid to S&P by Orange County in 1994.[61]

Jefferson Cty. Sch. Dist. No. R-1 v. Moody's Investors, Inc.[62]

In 1993, the Jefferson County School District decided to issue refunding bonds. Although it retained Moody's in the past, the School District chose two other CRAs to rate its bonds and did not provide any financial information to Moody's about this issuance. However, Moody's published its "Rating News" stating that the plaintiff's financial condition was not creditworthy and distributed this "rating" to Moody's subscribers. Moody's uninvited rating negatively affected the plaintiff's bond issuance. The plaintiff, Jefferson County School District, sued Moody's on three counts: (a) intentional interference with contractual and business relations; (b) materially false, misleading and derogatory statement; and (c) violations of the antitrust laws.[63] Like S&P in the Orange County case, Moody's argued for protection of expressions of opinion under the First Amendment;[64] the court deemed this argument sufficient to grant a motion to dismiss.

Abu Dhabi Comm. Bank v. Morgan Stanley & Co.[65]

Abu Dhabi Commercial Bank together with other plaintiffs brought a lawsuit against defendants including S&P and Moody's for "common law fraud, negligent misrepresentation, negligence, breach of fiduciary duty, breach of contract, unjust enrichment, tortious interference with contract, and aiding and abetting."[66] The plaintiffs, contending that the CRAs produced false and misleading "top ratings" of Cheyne SIV Rated Notes issued to a select group of investors, sought compensation from the liquidation of notes. Morgan Stanley acted as the placement agent and engaged the CRAs to rate the debt offerings. In exchange for "top ratings" of the structured Cheyne SIV's portfolio, the CRAs received three times the normal fees for devising ratings. The Cheyne SIV went bankrupt in the crisis of subprime mortgages. The court denied the CRA's motion to dismiss the fraud claims. Unlike *County of Orange* and *Jefferson Cty. Sch. Dist.*, this case marks a significant turning point as the court rejected the CRA's free speech argument.[67]

Common Themes and Recent Cases

A common theme in these cases is the CRAs' use of the First Amendment as its primary defence against liability for CRAs' ratings. For instance, CRAs stress

[61] *County of Orange*, 245 B.R. 151.
[62] 988 F. Supp. 1341 (D.C. Colo. 1999).
[63] Ibid at 1341.
[64] 245 B.R. 151 (C.D. Cal. 1999).
[65] 651 F. Supp. 2d. 155 (S.D.N.Y. 2009).
[66] Ibid at 176.
[67] Ribe (2010).

that their ratings are "pure opinion" or "public opinion;"[68] while plaintiffs argue CRAs should be subject to liability for issuers' misstatements or "hostile ratings."[69] Most recently, plaintiffs have brought "a broad array" of lawsuits against rating agencies in connection with structured investment vehicles based upon a few common law liability theories: breach of contract, negligence, fraud, and fiduciary duty.[70] One article provides a particularly apt summary of securities class action lawsuits as of November 15, 2008: there were approximately eighty 10b-5 related lawsuits and there were approximately twenty-four lawsuits concerning either Section 11 or 12(a) (2) liability.[71] Many of these lawsuits were filed in 2007 and 2008 after the "global credit crisis." In the trial of these lawsuits, courts have broken through previous barriers (such as the CRAs' use of the defences of press privilege and pure opinion) in imposing liability for ratings.[72]

In 2013, Department of Justice (DOJ) sued Standard & Poor's for fraud. S&P reached a settlement with DOJ to pay USD1.375 billion.[73] In January 2017, DOJ settled with Moody's and Moody's agreed to pay USD864 million for pre-crisis MBS ratings.[74] Based upon these cases, rating agencies should greatly raise their negligence standard of care, considering the factors of public interest, their role of "gatekeeper" and the increased global accountability on the part of rating agencies.

Major CRAs in China

China Chengxin Credit Rating Group

Founded in October 1992 as the first national credit rating agency approved by the PBoC, China Chengxin has become a leading credit rating provider. In 2006, China Chengxin established a joint venture with Moody's. Moody's brings internationally advanced rating technologies and methodological systems into CCXI. As a leading rating service provider in enterprise bonds, short-term financial bonds, structured financial products and debt financing instruments, China Chengxin Group, which is composed of China Chengxin (Asia Pacific) Credit Ratings Company Limited, China Chengxin International Credit Rating Company Limited, China Chengxin Securities Rating Company Limited, China Chengxin Credit Information Company Limited, and China Chengxin Credit Management Company Limited, is China's largest CRA.[75]

China Chengxin has obtained various rating qualifications granted by the regulatory authorities, such as PBoC, CBIRC, NDRC, State Economic and Trade Commission, Beijing Financial Assets Exchange, and Beijing Zhongguancun

[68]Freeman (2009).
[69]Examples include *Compuware Corp. v. Moody's Investors Servs. Inc.,* and *New Jersey Carpenters Vacation Fund v. HarborView Mortgage Loan Trust.*
[70]McGuinness (2009).
[71]Ferrell, Bethel & Hu (2008).
[72]Freeman (2009).
[73]DOJ (2015).
[74]DOJ (2017).
[75]CCXAP, www.ccxap.com/About.aspx.

Management Committee.[76] In October 2010, it received Type 10 license in Hong Kong. Over the past two decades, China Chengxin has achieved many first places in China's credit rating industry in corporate rating domestic corporate bonds, financial institutions, local government bonds, and structured products.[77]

Dagong Global Credit Rating Co., Ltd.

Dagong Global Credit Rating Co., Ltd. (Dagong Global) was founded in 1994 with the approval of the People's Bank of China and the previous State Economic and Trade Commission. As a nationally recognised credit rating company, Dagong Global has 600 staffs working in 34 domestic branches and two overseas branches.[78] In 2018, Dagong's market share in China accounted for about 20%.[79] In order to improve the internationalization of China's credit system and the construction of credit and information service market, Dagong Global signed a cooperative framework agreement with the Xinhua Net.[80]

Dagong Global pursues to reveal the connection between credit rating and social and economic development, reform the international credit rating system and develop the responsibility of credit rating.[81] After the global financial crisis, Dagong Global built its sovereign rating standard as the first sovereign ratings in China.[82] In the summer of 2010, Dagong Global issued China's first sovereign ratings report, which lowered the ratings of advanced countries (e.g. U.S., U.K. and France) and raised ratings of emerging markets.[83]

In September 2010, Dagong Global applied to the Securities and Exchange Commission (SEC) for registration as a NRSRO. However, the SEC denied its application for the reason that Dagong Global was not possible to "comply with the recordkeeping, production, and examination requirements of the federal securities laws".[84]

In order to realise its internationalization strategies, Dagong Europe Credit Rating Srl (Dagong Europe) was founded in Italy and registered as an European CRA in June 2013.[85] In July 2014, Dagong Global Credit Rating (Hong Kong) Co., Ltd. (Dagong HK) obtained the Type 10 license granted by the Securities and Futures Commission of Hong Kong (SFC). Dagong HK provides credit ration services for both entities and issuances, one-time and on-going, solicited and unsolicited, as well as both private and public ratings.[86]

[76]This information is according to an interview with China Chengxin in November 2015.
[77]CCXAP, http://www.ccxap.com/About.aspx.
[78]Dagong Global, http://en.dagongcredit.com/index.html.
[79]Richter (2018).
[80]Xinhua Net (2009).
[81]Dagong Global, http://en.dagongcredit.com/.
[82]Ibid.
[83]Li (2010).
[84]SEC (2010).
[85]See the ESMA list of registered and certified CRAs as of June 3, 2013.
[86]Dagong HK, http://www.dagonghk.com/AboutUs.php?act=list&parent_id=19&menu_id=251.

China Lianhe Credit Rating Co., Ltd.

China Lianhe Credit Rating Co., Ltd. (China Lianhe) was founded on the basis of restructuring of Fujian Province Credit Rating Committee in January 2000 in Beijing. Its registered capital is RMB 136 million yuan. In August 2007, China Lianhe established a joint-venture CRA with Fitch. At present, United Credit Management Limited holds 51% shares of China Lianhe as the controlling shareholder; Fitch holds 49% shares of China Lianhe.[87] China Lianhe has obtained all credit rating qualifications in China's capital markets and credit markets granted by the NDRC, PBoC, CSRC, CBIRC and Ministry of Industry and Information Technology (MIIT). In 2015, China Lianhe undertook 1,101 rating projects, including 1,032 initial rating projects; It participated ratings of 624 bonds, whose issue volume was RMB 1.12 trillion yuan.[88]

Shanghai Brillance Credit Rating & Investors Services Co., Ltd.

Shanghai Brillance Credit Rating & Investors Services Co., Ltd. (Shanghai Brilliance Rating) was founded in July 1992. As the first Chinese CRA that obtained all qualification and licenses (including License of Enterprise Bond Rating and License of Inter-bank Market Ratings granted by PBoC, License of Enterprise Bond Ration granted by NDRC, License of Eligible CRA granted by CBIRC and License of Corporate Bond Rating granted by CSRC) from Chinese supervisory authorities, it has established a technical cooperation with Standard & Poor's Ratings Services (S&P). Its ratings cover commercial paper, medium-term notes, corporate bonds, enterprise bonds, small and medium enterprises (SMEs) collective notes, financial bonds, asset-backed securities, local government bonds.[89] In particular, Shanghai Brilliance Rating has obtained quite a few first places in China's credit rating industry. It issued the first investment value report for Tsingtao Brewery Company Limited in 1994, the first bond rating of a securities company for Guotai Junan Commercial Paper in 2005, the first three ratings of collective notes of SMEs in 2009, the first foreign RMB-denominated bond rating for the Bank of Tokyo-Mitsubishi UFJ (China), Ltd. in 2010, and the first local government bond rating for Guangdong Province in 2014.[90]

The Multiple Regulatory System of China's Credit Rating Industry

In corresponding to the segmented regulatory system of China's bond market, its credit rating industry is regulated by multiple authorities. The People's Bank of China is the regulator of interbank bond market bond rating, which concerns issuance of treasury bonds, government bonds, municipal bonds, central bank bills, short-term financial bonds, non-banking financial bonds and asset backed

[87]China Lianhe, www.lhratings.com.
[88]Ibid.
[89]Shanghai Brilliance Ration, www.shxsj.com.
[90]Ibid.

securities (ABS). China Securities Regulatory Commission is the regulator of exchange market bond rating, which concerns corporate bonds, government bonds and convertible bonds. In addition, credit ratings relating to issuance of enterprise bonds and certain bonds invested by insurance capitals must be accredited by the National Development and Reform Commission (NDRC) and China Banking and Insurance Regulatory Commission (CBIRC) respectively. Prior to 2019, a CRA applying for the license to engage in securities rating services from the CSRC must have Chinese legal person qualification.[91]

Multiple Regulators

Prior to the establishment of the exchange bond market, the PBoC was the single regulator of the ratings market. The segmented bond market and the split supervisory system of financial market lead to a multiple regulator system for the ratings market. Accordingly, the rating activities are regulated by the following authorities:

	The Inter-bank Bond Market (The PBoC as the Major Regulator)	**The Exchange Bond Market (CSRC as the Major Regulator)**
PBoC	Commercial paper (CP), ultra-short-term financial bonds with a term of 270 days issued by non-financial enterprises, medium-term notes (MTN), small and medium-sized enterprises collection notes (SMECN), and private placement notes (PPN)[92] and project revenue note (PRN) in the inter-bank bond market	
CSRC		The CSRC and its dispatched offices shall supervise and administrate the securities rating business activities,[93] including: Short-term bonds issued by securities companies, corporate bonds, non-publicly issued corporate bonds (including privately raised SME bonds) and securitization products in the exchange market.
CBIRC	Financial bonds issued by commercial	

[91]Article 7 of the *Interim Measures for the Administration of the Credit Rating Business Regarding the Securities Market* issued by the CSRC on August 24, 2007.

[92]"Private placement notes", also called as "private placement bonds of small and medium enterprises", refer to the corporate bonds non-publicly issued and transferred by micro, small and medium enterprises within the territory of China, with principal and interest repaid within an agreed time limit". See Article 2 of the *Shanghai Stock Exchange on Issues Concerning the Issuance and Implementation of the Pilot Measures of the Shanghai Stock Exchange for the Issuance of Private Placement Bonds of Small and Medium Enterprises* enacted on May 22, 2012.

[93]Article 6 of the *Interim Measures for the Administration of the Credit Rating Business Regarding the Securities Market* issued by the CSRC on August 24, 2007.

	The Inter-bank Bond Market (The PBoC as the Major Regulator)	**The Exchange Bond Market (CSRC as the Major Regulator)**
	banks, financial companies, financial lease companies, Tier 2 capital bonds of commercial banks, securitization products in the inter-bank bond market (former CBRC); Subordinated debts of insurance companies (former CIRC)	
MOF	Local Government Debts	Local Government Debts
Ministry of Commerce (MOC)	Short-term bonds and medium-term notes issued by non-financial lease companies	
NDRC	Enterprise bonds, project revenue bonds, small and medium enterprises collection notes, and micro and small enterprises support bonds in the inter-bank bond market	Enterprise bonds, project revenue bonds, small and medium enterprises collection notes, and micro & small enterprises support bonds in the exchange market

Cross Supervision

In corresponding to the multi-supervisory system of bond market, the credit rating business is subject to the supervision of multiple supervisory authorities, including PBoC, CSRC, CBIRC,[94] NDRC, MOF, MOC, as well as two self-regulatory organizations – NAFMII and SAC. Of these organizations, PBoC and NAFMII are the main supervisors of ratings in the inter-bank bond market; the CSRC and SAC are the main supervisors of ratings in the exchange market. The multi-regulatory system derives from the split regulatory system of the bond market. Since different regulators may pursue different supervisory criteria and enforcement policies, in practice, it may result in regulatory loopholes and regulatory arbitrage.

Under the multiple supervisory system of credit rating industry, some credit rating activities are subject to cross supervision: (i) Ratings of debt financing instruments issued by non-financial institutions such as commercial paper (CP), ultra-short-term financial bonds with a term of 270 days issued by non-financial enterprises, medium-term notes (MTN), small and medium sized enterprises collection notes (SMECN), and private placement notes (PPN) and project revenue notes (PRN) in the inter-bank bond market are subject to the supervision of the PBoC and NAFMII; (ii) Ratings of enterprise bonds, project revenue notes, small and medium sized enterprises collection notes, which are approved by the NDRC and traded in both the inter-bank bond market and the exchange market, are subject to the supervision of the NDRC, PBoC, CSRC, NAFMII and SAC; (iii) Ratings concerning financial bonds issued by commercial banks in the inter-bank bond market are subject to supervision by the PBoC, CBIRC and NAFMII; (iv)

[94]China Banking Regulatory Commission and China Insurance Regulatory Commission merged as China Banking and Insurance Commission (CBIRC).

Ratings of bonds issued by insurance company in the inter-bank bond market are subject to the supervision of the PBoC, CBIRC and NAFMII; (v) Ratings of financial bonds issued by financial companies and financial lease companies are subject to the supervision of CBIRC, PBoC and NAFMII; (vi) Ratings of short-term bonds and medium-term notes issued by non-financial lease companies are subject to supervision of the PBoC, MOC and NAFMII; (vii) Ratings of securitization products issued in the inter-bank bond market are subject to the supervision of the PBoC, CBIRC and NAFMII; (viii) Ratings of securitization products in the exchange market are subject to the supervision of the CSRC and stock exchange(s); (ix) Ratings concerning local government debts in the inter-bank bond market are subject to the supervision of the MOF, PBoC and NAFMII; (x) Ratings concerning local government debts in the exchange market are subject to the supervision of the MOF, CSRC and stock exchange(s); (xi) Ratings of corporate bonds and private placement bonds are subject to supervision of the CSRC and stock exchange(s).

Two Self-regulatory Organizations (SROs): NAFMII and SAC

The National Association of Financial Market Institutional Investors (NAFMII) was founded in September 2007 in Beijing with the approval of the State Council. As of April 2012, members of the NAFMII were composed of 141 banks, 131 non-bank financial institutions, 5 financial service intermediaries, 475 intermediaries including credit rating agencies, 1911 corporations, Ministry of Railways and National Council for Social Security Fund.[95] The NAFMII enacted the *Self-regulatory Guideline for Credit Rating Business of Non-financial Enterprise Debt Instruments*, which was implemented on January 8, 2013, in accordance with the *Administrative Measures for Debt Financing Instruments of Non-Financial Enterprises in the Inter-bank Bond Market*. This self-regulatory guideline encourages double ratings.[96] The NAFMII recognises six CRAs' ratings in the inter-bank bond market, including China Chenxin, Lianhe, Dagong Global, Shanghai Brilliance, China Bond Rating, and Golden Credit Rating.[97] Recently, NAFMII is enhancing its self-disciplinary rules over CRAs' conflict of interest, inflated credit scores and consulting fees. CRAs. In March 2018, NAFMII issued guidelines for registration and assessment of credit rating agencies, which concerned both the interbank bond market and non-financial enterprises' debt instruments. In May 2019, NAFMII issued disclosure rules for credit rating business concerning interbank bond market and debt financing instruments of non-financial enterprises.[98]

The Securities Association of China (SAC) was founded in August 1991 in Beijing. Members of the SAC are composed of 109 securities companies, 84 securities investment consulting institutions, 6 CRAs, the China Great Wall Asset

[95]NAFMII, www.nafmii.org.cn.
[96]Article 6 of the NAFMII's *Self-regulatory Guideline*.
[97]NAFMII, www.nafmii.org.cn.
[98]NAFMII, "Self-Disciplinary Rules", http://www.nafmii.org.cn/zlgz/.

Management Corporation (CGWAMC), and other ordinary and special members.[99] The SAC recognises six ratings of CRAs in the exchange market, including China Chenxin, Lianhe, Dagong Global, Shanghai Brilliance, Golden Credit Rating, and Penyuan.[100] Under the *Interim Measures for the Administration of the Credit Rating Business Regarding the Securities Market*, the Securities Association of China (SAC) carries out the self-disciplinary management of securities-related ratings.[101] In September 2009, five accredited CRAs (China Chengxin, Dagong Global, China Lianhe, Shanghai Brilliance and Pengyuan Rating) signed the *Self-Disciplinary Convention of Credit Rating Industry*.[102] In January 2015, the SAC issued the *Detailed Rules for Implementation on Rating Business of Credit Rating Agencies in the Securities Market (Trial)*. This implementation rules stipulate criteria of business conduct for CRAs' due diligence, rating report, information disclosure and internal control.

Other Legal Issues Concerning Chinese CRAs

Market Access

In the *Catalogue for the Guidance of Foreign Investment Industries* (2015 Amendment), credit investigation and rating services are still listed as one of "restricted foreign investment industries".[103] Prior to April 2019, a foreign CRA must establish a joint venture with a Chinese CRA in order to get access to Chinese ratings market, upon the approval of the Ministry of Commercial. The shareholding ratio of a foreign CRA in the joint venture is capped at 49%. In September 1998, China Chengxin and Fitch Ratings established China's first joint-venture CRA--China Chengxin International Credit Rating Co. In 1999, Dagong Global and Moody's announced their technological cooperation. In 2006, Moody's acquired 49% shares of China Chengxin International Credit Rating Co., Ltd. In May 2008, Fitch Ratings acquired 49% shares of China Lianhe. In August 2008, Standard & Poor's signed strategic cooperative agreement with Shanghai Brillance Credit Rating & Investors Services Co., Ltd.[104] Big Three CRAs have greatly promoted rating business of their business partners. In 2010, three major CRAs—China Chengxin, Lianhe Credit, and Dagong Global —accounted for 95% of domestic market share.[105]

The access to credit rating services in bond markets has been strictly managed by relevant regulators since mid-2000s. Of the Chinese CRAs that engage in

[99]SAC, "Credit Rating Institutions", www.sac.net.cn.
[100]SAC, "Credit Rating Institutions", http://www.sac.net.cn/en/SAC_Members/4/.
[101]Article 6 of the *Interim Measures for the Administration of the Credit Rating Business Regarding the Securities Market* issued by the CSRC on August 24, 2007.
[102]Hou (2009).
[103]See Item 29 of "Restricted Foreign Investment Industries" promulgated by the NDRC and Ministry of Commerce on March 10, 2015. Credit rating services have been categorised as "restricted foreign investment industry" since 2007.
[104]Shanghai Brilliance Rating (2012).
[105]Wang & Wheatley (2010)

nationwide credit rating business, four major CRAs (China Chengxin, Dagong Global, China Lianhe and Shanghai Brilliance) have full licensing accredited by four government authorities (PBoC, CSRC, NDRC and CBIRC) to provide rating services in both inter-bank bond market and exchange bond market.

	NDRC[106]	**PBoC**[107]	**CSRC**[108]	**CBIRC**[109]
Chengxin	✓	✓	✓	✓
Lianhe	✓	✓	✓	✓
Dagong	✓	✓	✓	✓
SH Brilliance	✓	✓	✓	✓
Pengyuan			✓	
China Bond Rating		✓		✓
Golden Credit		✓		
Fareast Credit	✓			✓

To reform the issuer pays model, China Bond Rating Co., Ltd. was founded by the NAFMII on behalf of all its members in August 2010. Its registered capital is RMB 50 million. This is the first CRA that adopts "investor pays model" in China.[110] It is also a re-rating agency. The business goal is to accumulate rating data of various industries in the inter-bank bond market and it is supposed to quit in five to ten years.[111]

Avoidance from Conflicts of Interest

Since China's credit rating industry has a short history, the reputational mechanism does not work well and the competition for high rating grades has been serious.[112] In March 2006, Fuxi Investment Holding Limited issued the first phase of its short-term bonds -- "06 Fuxi CP01" whose issuing scale was CNY 1 billion and was due in March 2007. This is the first short-term financial bill issued by a non-listed privately operated (*Minying*) enterprise. "06 Fuxi CP01" was rated as "A-1" by Shanghai Far East Credit Rating Co., Ltd. (Shanghai Far East Rating) on December 28, 2005. However, Fuxi Investment involved in the scandal of Shanghai social security fund and some assets were frozen by the court in July. On July 26, 2006, Shanghai Far East Rating initiated the tracking rating system and announced the rating of "A-1" became temporarily invalid. [113] Thereafter, plenty

[106]Notification of NDRC Finance No. [2003] 1179 (11 September 2003).
[107]*Guiding Opinions on the Credit Ratings Management of the People's Bank of China* (29 March 2006).
[108]*Interim Measures for the Administration of the Credit Rating Business Regarding the Securities Market* issued by CSRC (24 August 2007).
[109]*Announcement of the China Insurance Regulatory Commission on the Recordation of Recognised Capability of the Credit Rating Institution* (9 October 2013).
[110]China Bond Rating Co., Ltd., www.chinaratings.com.cn.
[111]Baidu Baike, "China Bond Credit Rating Co.", http://baike.baidu.com/view/4413444.htm.
[112]Yuanfan Zhou (2012).
[113]Xu & Gao (2006).

of Fuxi's bonds were undersold.[114] On August 21, 2006, Shanghai Far East Rating downgraded the rating of "06 Fuxi CP01" to grade "C" for the reason of undisclosed loan guarantees for one of its shareholders, and thus became the first junk bond in Mainland China. The "Fuxi Event" called into question on the authority of domestic rating agencies. This event also negatively affected the reputation of Shanghai Far East Rating and its rating business declined thereafter.[115]

Take the example of the "AAA" rating of the Ministry of Railways. On August 8, 2011, the Ministry of Railways issued ninety-day super-short term financial bonds which valued at CNY 20 billion and the interest rate of bid winner was 5.55%. These bonds were rated as grade "AAA" by Dagong Global. This news gave a surprise to the public media since the Ministry of Railways had quite a lot negative news (e.g. the bullet train accident in Wenzhou on July 23, 2011) at that time. It turns out that the interest margin for each grade of "AAA", "AA" and "A" is about 30 basis points. In other words, the issuer may save CNY 150 million for raising one rating grade on the basis of issuing scale of CNY 20 billion.[116] The short-term bills issued by the Ministry of Railways are regards as "equivalent to national debts" because the Ministry of Railways bonds get implicit financial guarantee from the central government.[117]

However, the grade "AAA" was questioned by the public because it was even higher than the grade "AA" of China's national debts. In the first half of 2011, the debt ratio of the Ministry of Railways reached 58.33% (CNY 2.09 trillion in total with an annual interest of more than CNY 6 billion) but the accumulated net profit was only CNY 1.7 billion, according to its financial report.[118] Regarding the challenge of grade "AAA" of short-term railways bonds, the Dagong Global explained that the Ministry of Railways was both a state department and an enterprise legal person. If the Ministry of Railways was not able to pay the short-term bills, the state would pay back.[119] Further investigation shows that Dagong Global was the exclusive credit rating agency for the Ministry of Railways. The credibility of Dogong Global's "AAA" rating for railways bills indicates conflicts of interest between a CRA and its rated entity.[120]

[114]According to the CSRC's requirement at that time, monetary market funds should invest in grade "A-1" or above short-term bonds; when there is a downgrade and the rating of short-term bonds is lower than "A-1", the short-term bonds must be sold in 20 trading days after the downgrade report is released. See Article 3 of the *Circular of China Securities Regulatory Commission on the Investment of Monetary Market Funds in Short-term Financing Bonds* issued by the CSRC on September 22, 2005 and became invalid.
[115]Gao (2006).
[116]CNFOL (2011).
[117]Ibid.
[118]Peng (2011).
[119]Qiao & Gao (2011).
[120]CNFOL (2011).

Independence of CRAs

In order to enlarge their market share, connections with local governments or financial institutions have been important for Chinese CRAs. An examination shows that Chinese CRAs may include local government or FIs in their shareholding structure. As a matter of fact, most Chinese CRAs had government background when they were incorporated in the 1990s. For example, large shareholders of Shanghai Brilliance Credit Rating Co. are China Foundation for Development of Financial Education (CEDF), Shanghai University of Finance and Economics, Shenergy Co., Ltd. and Shanghai Tiancheng Investment and Industrial Company.[121] Dagong Global was founded by eight entities including China Finance Society, China Academy of Social Sciences (CASS), China Aviation Science and Technology Committee, State Council Development Research Center, China Enterprise Association, China Enterprise Management Association and China Institute of Finance in June 1992.[122] Initially, China Lianhe was founded as Fujian Province Credit Rating Committee in 1995.[123] In 2009, Tianjin TEDA, a financial platform of Tianjin Government, acquired 50% shares of China Lianhe.[124] In 1988, Shanghai Far East Credit Rating Co. was founded by Shanghai Academy of Social Sciences, Shanghai Banking Information Consultation Center and Shanghai Academy of Social Sciences World Economy Institute.[125]

After Chinese CRAs' establishing joint ventures with the "Big Three" (Moody's, S&P's and Fitch) in mid-2000s, state capitals started to acquire shares of privately operated CRAs too. The first acquisition with state capital background was conducted by the Dongfang Asset Management Company Ltd. ("Dongfang AMC"). In August, 2007, Dongfang AMC signed the share transfer agreement with the Golden International Credit Rating Co., Ltd. and held 60% shares of the latter. The acquired CRA was renamed as "Dongfang Golden Credit Rating Co., Ltd.".[126] In December 2008, Dongfang AMC purchased 51% shares of Shanghai Far East Credit Rating Co., Ltd. and the latter became a subsidiary of Dongfang AMC group.[127]

In 2009, state capitals engaged in the third acquisition of a privately operated CRA. Tianjin TEDA International Holding (Group) Co., Ltd. (TEDA Holding), which was founded by the Administration Committee of Tianjin Economic-Technological Development Area ("TEDA") as a local government platform to manage state-owned assets, purchased 50% shares of Lianhe Credit Rating Co., Ltd. (Lianhe Rating). Although Lianhe Rating did not need raise its capital and the joining of state capital did not add its credibility, Lianhe Rating was welcome to

[121]Baidupedia, "Shanghai Brilliance Credit Rating Co., Ltd.". http://baike.baidu.com/view/8514014.htm.
[122]Baidupedia, "Dagong Global Credit Rating Co., Ltd.". http://baike.baidu.com/view/4008050.htm.
[123]Dagong Credit Rating, "China's Credit Rating Agencies", http://en.dagongcredit.com/.
[124]Gao (2009).
[125]Dagong Credit Rating, "China's Credit Rating Agencies", http://en.dagongcredit.com/.
[126]Gao (2009).
[127]Ibid.

this acquisition because TEDA Holding controlled approximately 80% financial assets in Tianjin.[128]

After December 2008, Dongfang AMC had two CRAs in its affiliated group - Shanghai Far East Credit Rating Co., Ltd. and Dongfang Golden Credit Rating Co., Ltd. (Dongfang Golden). After a restructuring of shareholding structure, Dongfang AMC held 83% shares of Far East Rating. The two CRAs competed each other a couple of years, and finally Dongfang Golden obtained all rating licenses in both inter-bank bond market and securities bond market. Dongfang AMC decided to sell the Far East Rating. In November 2012, China Development Bank (CDB), China's biggest government-backed policy bank, took over the Fareast Rating at the price of CNY 60.5 million.[129]

In another example, Pengyuan Credit Rating Co., Ltd. (Pengyuan Rating) is a Shenzhen-based CRA with the background of state capitals. Pengyuan Rating has two shareholders: the Shenzhen Financial Electric Settlement Centre and the Shenzhen Chengben Credit Service Co., Ltd. The first shareholder is a subordinate of the PBoC.[130] Since CRAs are supposed to play a third-party intermediary in the financial market, being controlled by state capitals or financial institutions may affect their status as an independent financial intermediary.

In accordance with the CSRC rules, CRAs are forbidden from carrying out securities rating business for a rated entity in certain circumstances, where concern actual or potential conflicts of interest with the actual controller, a shareholder of the CRA's 5%+ shares, CRA's management, analysts and their intermediate relatives.[131] When a CRA's controlling shareholder or actual controller is a financial institute, the CRA may not be able to play an independent role when involving in the above-mentioned conflicts of interest. In addition, state capitals should avoid involving in the rating services in order to keep the independence of CRAs and avoid from conflicts of interest.

Competition and "Rating Shopping"

By 2011, there were more than 200 CRAs in China and the competition for limited market resources was critical. The issuer pays model played a dominant role in the ratings market. It turned out that rating charges were positively correlated to rating grades and the rating shopping was serious. Rating fees rise on a scale of high to low. In other words, the issuer paid more for higher ratings.[132] In practice, the bond issuer chose a CRA through bidding. That is, whoever provides higher rating and lower fees win the bidding.[133]

It is reported that the CRA only charged CNY 50,000 for a tranche of bonds up to CNY25.8 billion in Anhui. The reason for such a low charge is that

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[128]Ibid.
[129]Qiao (2013).
[130]Caijing (2008).
[131]Article 12 of the *Interim Measures for the Administration of the Credit Rating Business Regarding the Securities Market* issued by the CSRC on August 24, 2007.
[132]China Economic Net (2011).
[133]Qian (2011).

institutional investors do not really recognise the rating reports from CRAs. Since many CRAs have to use lower charges as a strategy to compete with their rivals, the profit of credit rating industry does not really rise accompanying the growth of bond markets. In particular, the market for credit ratings of SMEs bonds and local government bonds are quite competitive. In order to get business, local CRAs not only give inflated “AAA” rating to local government bonds but also charge small rating fees.[134] For example, Dongfang Golden Credit Rating Co. only charged CNY 80,000 for the credit rating of Shanxi Province government bonds.[135]

Another example is Dagong’s scandal in 2018. On August 17, 2018, NAFMII announced that Dagong was found to have “directly provided consulting services to rated companies” and overcharged high fees from November 2017 to March 2018. Additionally, the investigation by the China Securities Regulatory Commission (CSRC) indicated that Dagong has serious governance problems in “charging consulting fees from those being rated”, “hiring executives without professional qualifications” and losing “original documents for some rating services”. Thus, both NAFMII and CSRC decided to suspend Dagong’s domestic rating services for a year.[136] In April 2019, Dagong Global was taken over by the China Reform Holding Corp. Ltd., a state-controlled asset manager. This acquisition turns Dagong Global into a state-owned frim.[137]

On the other hand, institutional investors may not take credit ratings seriously due to the rigid redemption in China’s bond market. By June 30, 2018, 97% of 1,744 Chinese bond issuers were rated with AA and above, of which 464 bond issuers obtained the highest rating.[138] The rigid redemption resulted in the mismatch of credit ratings and risk premium.

Inflated Ratings and Accountability of Credit Rating Agencies

As of April 30, 2015, 22.5% Chinese onshore bonds were unrated.[139] Of the 77.5% rated onshore bonds, 34.8% onshore bonds were rated by international rating agencies, 35% onshore bonds were rated by domestic rating agencies, and 7.8% were rated by both international and domestic agencies.[140] Credit Rating Ranks in the inter-bank bond market is as follows:

[134]Yuan (2015).
[135]Cao (2015).
[136]Wang (2018).
[137]Peng, Zhang & Shen (2019).
[138]Wang (2018).
[139]Manulife Asset Management (2015) at 7.
[140]Ibid.

Credit Rating Ranks for Medium and Long-term Bonds	**Credit Rating Ranks for Short-term Bonds**
AAA	A-1
AA	A-2
A	A-3
BBB	B
BB	C
B	D
CCC	
CC	
C	

However, it is common that the same rated entity got different ratings between domestic market and international market, between external ratings and internal ratings of commercial banks, or between inter-bank bond market and exchange bond market. Under the issuer pays model, inflated ratings are welcome to CRAs' clients. For example, some CRAs issue high grades of ratings. It is reported that Dagong Global issued 156 "AAA" grades for central enterprise bonds and corporate bonds of local governments' financial vehicles in 2010, including 15 credit ratings for enterprise, 3 enterprise bond ratings, 113 tracking ratings, 4 corporate bond ratings, 2 credit ratings for financial bond and 19 medium-sized notes. The 156 "AAA" grades accounted for 25% out of 624 ratings released on Dagong's website.[141]

Therefore, the accountability of some CRAs has been questioned. Regarding domestic credit ratings, internal credit rating departments of commercial banks usually issue lower rating grades than external rating agencies for the same rated entity or bonds. For example, small-sized local rating agencies appear to give higher ratings due to the intense competition for credit rating business.[142] Also, some cases show that CRAs may not follow rating procedure all the time. In March 2012, the Shanghai Chaori Solar Energy Science and Technology Company ("Chaori") issued three-year "Chaori-11 bond" (sz112061), which was rated by Pengyuan Credit Rating Co. Ltd. ("Pengyuan") as grade "AA" on July 13, 2011. However, Pengyuan failed to issue the tracking ratings within one month after Chaori announced its annual financial report. Pengyuan was warned by the Shenzhen Securities Regulatory Bureau for violating the rating procedure that Pengyuan submitted to the regulatory authority and late issuance of tracking rating for Chaori-11 bond. In 2014, Chaori-11 Bond (sz112061) became the first domestic corporate bond default.

In addition, it is noted that credit ratings assessed by domestic CRAs may be not equivalent to credit ratings assessed by international CRAs. Approximately, the domestic agency ratings of [AA, AA+ and AAA] are corresponding to international agency ratings of [BB, BB+, BBB-, BBB, BBB+, A-, A, A+ and AA-].[143] In other words, credit ratings assessed by China's domestic agencies are

[141]Hu, Li & Chen (2011).
[142]Song (2014).
[143]Manulife Asset Management (2015) at 7.

generally higher than credit rating assessed by international agencies. For example, in June 2015, three mainland CRAs – Dagong Global, China Lianhe and China Chengxin – gave an "AAA" rating for Evergrande Goup's newly issued HK$6.3 billion domestic bond, which was much higher the non-investment grade rating given by "the big three" and Standard & Poor's just downgraded Evergrande Group's rating from "BB-" to "B+".[144] Another example is the disagreement between the mainland and international CRAs on the rating of Gazprom, the previous Russian Ministry of Gas Industry - Gazprom was given a "Baa3" by Moody's; while Dagong Global gave an "AAA" for Gazprom.[145] According to a BIS working paper in 2017, ratings of Chinese bonds issued offshore, which were graded by international CRAs, were approximately six to seven notches lower than their ratings issued onshore and graded by Chinese domestic CRAs.[146] Other empirical study also indicated that rating criteria varied substantially among different Chinese CRAs.[147]

Accompanying the increasing debt defaults and accumulating financial risks in China's financial system in recent years, the inflated ratings and credibility of some CRAs may be questioned. For example, of the corporate bond defaults totalling USD8.3 billion from January to September 2018, some companies were rated high scores (AA+ ratings) by domestic CRAs in 2017.[148] As a matter of fact, the WIND database shows that about 80% of onshore issued renminbi bonds were rated AA or above; ironically, six CRAs upgraded ratings as defaults increased in 2018.[149]

Aside from economic factors, policy risk matters in rating Chinese bonds. According to the Manulife Asset Management, questions such as "whether the rated entity is a SOE" and "whether the rated entity is a central SOE" are directly related to access to bank loans, state subsidies and government support. As to the private companies, their business must fit into the government's policy orientation.[150]

The First P2P-related Credit Rating Case: Duanrong Net v. Rong 360

China is the largest country for online lending and it accounted for about 75% of the global market.[151] However, credit rating ranks for P2P lending is an underregulated area in China. Ratings and ranks on the same peer-to-peer lending platform graded by different rating agencies often vary. For example, *Xin He Hui* was rated as "C-" and ranked as "97th" by a CRA - Rong 360, but was ranked as "19th" by another CRA – *Wang Dai Zhi Jia*.[152] The investigation shows that there are no universal criteria for P2P ratings and the authenticity of data about peer-to-

[144]Yam (2015).
[145]Ibid.
[146]Jiang & Packe (2017) at 2.
[147]Livingston, Poon & Zhou (2018) at 216–232.
[148]China Knowledge Newsletter (2018).
[149]Lockett & Jia (2019).
[150]Manulife Asset Management (2015) at 7.
[151]Wang & Dollar (2018).
[152]Lin (2016).

peer platforms are questionable; meanwhile, some CRAs have to "adjust" the result of ratings to cater for rated entities' needs.[153] This case raises the issues of unsolicited ratings and unfair competition.

Duanrong Net v. Rong 360 is the first lawsuit concerning peer-to-peer lending ratings. The plaintiff *Duanrong* Net sued the defendant *Rong* 360 after its lending platform was rated as "C" and "C-" by *Rong* 360. The plaintiff claimed for a compensation of CNY 10 million. The cause of action is defamation infringement. The plaintiff challenged the legitimacy of *Rong* 360's ratings because no CRAs got accredited from government authorities. The first court hearing was on December 15, 2015 at the Beijing Municipal Haidian District People's Court. The plaintiff did not recognise the unsolicited ratings made by the defendant. The People's University of China was added as a third party of the litigation since it was a cooperative partner of *Rong* 360's rating business.[154]

On December 27, 2016, Haidian District People's Court dismissed all plaintiff's claims on the basis of absent legitimate qualification for P2P ratings. The decision of this case may be significant to clarifying unsolicited ratings and ratings for fintech firms.[155]

Conclusion

The lessons from the role of CRAs in the subprime mortgage crisis raise critical issues such as conflicts of interest, accountability of ratings and liability of CRAs. As an emerging industry, China's credit rating services have made progress in credit rating procedure, methodology and reporting, accompanying the rapid development of China's bond market in the last decade. However, increasing debt defaults in recent years are challenging Chinese CRAs' rating results. Unlike their counterparties such as the Big Three, self-regulatory system especially the reputational mechanism is weak in the Chinese context. Furthermore, China's emerging credit rating sector operates under a multi-regulator system – the PBoC as the regulator of bond ratings on the nation's interbank bond market and the CSRC as the regulator of bond ratings on exchange market. This multi-regulatory system may result in inconsistent policies and regulatory arbitrage. In the near future, it may be adjusted in the financial system reform and structure reform.

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[153] Ibid.

[154] Beijing Haidian District People's Court (2018).

[155] Beijing Haidian District People's Court (2019).

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Has Thailand learnt any Lessons from the Bowring Treaty and the Treaty of Amity?

By Nucharee Nuchkoom Smith[*] *& Robert Brian Smith*[‡]

Thailand signed its first trade treaty with a European power with Portugal in 1516. Treaties with Spain, the Dutch followed. Arguably the two most significant treaties signed by Thailand in historical times were the Bowring Treaty signed with the British in 1855 and the Treaty of Amity and Commerce signed with the United States in 1833 and, following a number of replacements, the current version – the Treaty of Amity and Economic Relations was signed in 1966 and entered into force in 1968 at the height of the Vietnam War. The Bowring Treaty resulted in Thailand ceding its sovereignty over British subjects in Thailand to British law. This treaty lasted for 70 years. The Treaty of Amity originally provided more favourable benefits to United States enterprises than did the British under their earlier treaty of 1826. They were less favourable than those that were negotiated by the British in the Bowring Treaty. Thailand clearly ceded some of its sovereignty under these treaties and then sought to retrieve the situation over the following century. Since 1991 Thailand has been a party to negotiations for 30 Free Trade Agreements (FTAs) with 13 having entered into force. At the same time Thailand has signed 40 Bilateral Investment Treaties of which 37 have entered into force. The paper analyses whether or not Thailand has learnt lessons from the obligations imposed under its past treaties and as a result has it been advantaged or disadvantaged again during its post 1990 treaty obligations.

Keywords: *Trade agreements; Sovereignty; Thailand; Bilateral investment treaties; Extraterritoriality*

Introduction

In the past, Thailand, as a trading nation, often allowed trading partners to exercise extraterritoriality in return for concessions in international trade and also to protect its independence as a nation. The outcome was that the laws of foreign powers operated in Thailand in parallel with Thai laws. As will be seen the two most significant treaties were the *Bowring Treaty* and the *Treaty of Amity*.

With a strengthening of its legal and bureaucratic processes and practices in the early 1900s Thailand was able to extricate itself from such treaties.

There is still a real danger that, with the growth in international trade that trading partners will seek to impose their laws on Thailand's domestic laws. Often these requirements are in excess of what Thailand has committed to when signing an international treaty covering the same subject matter.

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This paper analyses whether or not Thailand has learnt lessons from the obligations imposed under its past treaties and as a result has it been advantaged or disadvantaged again during its post 1990 treaty obligations.

The paper will review Thailand's economic development and international trade from an historic perspective as this provides the platform for Thailand's continuing commitment to international trade. This is followed by an analysis of the key extraterritorial conditions of the two most significant treaties: the *Bowring Treaty* and the *Treaty of Amity*.

Since Thailand joined the World trade Organization (WTO) in 1995 it has been very active in protecting its interests both, in the WTO, and in negotiations for bilateral and plurilateral free trade agreements. Three case studies are presented. The collected data will then be analysed to see whether Thailand has learned from its previous experiences and has the capability and capacity to defend its national interests.

Historical Background

Thailand's modern economic development commenced with the foundation of Ayutthaya as its capital in 1351.[1] At this time, it was a river trading centre where people congregated for trade and worship. Ayutthaya remained the capital for 417 years during which time there were 33 kings and five dynasties – all absolute monarchs.

Thailand has a long history of international trade. The first treaty with a European country was a treaty of friendship and commerce with Portugal in 1516.[2] In return for guns and ammunition, the Portuguese were allowed to reside at Ayutthaya and other trading centres where they purchased agricultural products.

The Spanish, from Manila, negotiated a treaty of friendship and commerce in 1598. There was little increase in trade as Spain concentrated its trading interests with other countries.[3] In 1604 the Dutch were given permission to set up a trading post in Ayutthaya. The Dutch traded their cotton goods for animal hides and pepper. A treaty for the purchase of hides was signed in 1617.[4] The Japanese came to Ayutthaya as soldiers of fortune, adventurers, sailors and traders and by 1593 there were 500 Japanese soldiers in the Thai army.[5]

The English East India Company arrived in Ayutthaya in 1612 and was granted trading rights and land to build their trading warehouses. The English enterprises at Ayutthaya and Pattani were unprofitable so the company withdrew from Thailand in 1625.[6]

The credit for opening the relations between Thailand and France went to the French Catholic missionaries from the French Foreign Mission. In 1687

[1] Syamananda (1993) at 2.
[2] Ibid, at 43.
[3] Ibid. at 61.
[4] Ibid, at 63.
[5] Ibid, at 64.
[6] Ibid, at 65.

Thailand signed a commercial treaty with France allowing the French East India Company to trade at Ayutthaya without the payment of duties. Supplies of white saltpetre, black saltpetre, sulphur, firearms and weapons were to be secured from the Thai Government. The company also monopolised the tin business at Thalang Bangclee on Phuket Island.[7]

Most of these ties such as those with England and Spain did not result in long term trade for Thailand.[8]

When John Crawford was sent by the East India Company to negotiate a trade treaty in 1821, trade was a royal monopoly as all goods belonged to the absolute monarchy; taxation and trade were outsourced to Chinese merchants and tax-farmers who applied significant mark-ups.[9] The Thai government at the time lacked the resources to collect taxes so the government auctioned the monopoly to collect a particular tax in a geographical area for a set period with the 'tax farmer' paying to the government the agreed amount.[10] Unsurprisingly, the British were unhappy with the price of goods procured by this method and desired a commercial treaty which was more advantageous to them. The negotiations with Crawford broke down because the Thais required arms and ammunition in return for trading facilities and Thailand's insistence on a large sugar sale to Britain.

The United States entered into a treaty of commerce and amity in 1833.[11]

King Rama III (1824 to 1851) had a special interest in commerce. During this period the monarch established very strong trade relations with China. He also allowed Christian Missionaries, especially from the United States to enter Thailand.[12]

On 18 April 1855, Thailand and Britain signed the Bowring Treaty.[13] The Treaty provided Britain with extraterritorial rights over British citizens, removed all restrictions on trade and fixed very low import and export duties. "From the time of the treaty on, Siam was increasingly integrated into an international order dominated by Western powers. This process led to Siam's transformation into a modern nation-state"[14]

With the removal of barriers on trade, the Crown was forced to find new methods of raising revenues through direct taxation and indirect taxes on opium, gambling, alcohols and lotteries.[15]

Between 1850 and 1907 rice exports increased from 5% to 50% of the total crop due to an increase in acreage as well as intensifying production (p 46).[16] Over 80% of the rice exports went to Thailand's traditional markets of Hong Kong and Singapore.[17] Rubber, tin and teak were also major exports. There was a sharp

[7]Ibid, at 76 and 80.
[8]Ibid, at 61.
[9]Junsai (1991) at 8.
[10]See for instance Warren (2013); Ingram (1955) at 31-32; and Chuto (1987).
[11]Treaty of Commerce and Amity 1833.
[12]Syamananda (1993) at 108-111.
[13]Keyes (1989) at 44.
[14]Ibid.
[15]Ibid, at 45.
[16]Ibid, at 46.
[17]Owen (1971) at 99.

decrease in textile production as cloth and western goods came onto the market. The pattern for modern trade had been established.

Trade led to considerable improvements in infrastructure, particularly in Bangkok.[18] The new jobs created in Bangkok were overwhelmingly filled by Chinese immigrants who came to Thailand as non-agricultural labourers and traders. This was similar to other societies of countries in Southeast Asia as Thailand was becoming part of an international economic system, but "in other fundamental ways it evolved differently because, unlike those other societies, it was transformed politically by the indigenous elite rather than by Western colonial rulers".[19]

The Bowring Treaty was in effect for 70 years and was withdrawn under the reign of King Rama VI in 1925.[20] The government lost focus on the importance of maintaining its international relationships and trading partners due to its weakened financial situation as the result of excessive infrastructure spending as well as extravagant spending by the monarch.[21]

Keyes, writing in 1989, considers that:

> "*Thailand's relations with foreign countries have, since the Bowring Treaty [...] been shaped by two major concerns: the integrity of the nation-state and the development of international trade. These concerns have always led Thailand to orient itself toward those powers that were felt more likely to ensure the country's security and to provide markets for Thai products and sources for those goods Thailand wished to import.*"[22]

Little has changed since Keyes comment. Thailand's current concerns are still integrity of its borders and international trade. Thailand has an ongoing border dispute with Cambodia particularly the Temple of Preah Vihear, in Khmer, or Prasat Phra Wihan, in Thai, where there are periodic military skirmishes.[23]

Methodology

As has been seen Thailand has been participating in international trade for centuries often granting extraterritoriality in exchange for trading concessions. It could be argued that this was a result of lack of capacity and negotiating acumen on the part of the Thais. Alternatively, it could be seen as the Thai's willingness to lose some legal oversight of foreign nationals in return for profits that could be obtained by being more competitive and hence more profitable in international commerce.

[18]Keyes (1989) at 48.
[19]Ibid.
[20]Syamananda (1993) at 158.
[21]Paitoonpong & Abe (2014) at 4.
[22]Keyes (1989) at 111-112.
[23]See for instance: Sothirak (2013); Burgess (2015) at 193-226.

The research uses the narrative/case study approach to examine the lessons that can be learned from the past. It then focuses on three case studies from post-1995 to the present to see whether the lessons have indeed been learned.

Findings - *The Era of Extraterritoriality in Treaties with Foreign Powers*

Bowring Treaty

The *Treaty of Friendship and Commerce between Siam and Great Britain*[24] was signed at Bangkok on 18 April 1855.

The interests of British subjects entering Siam were placed under the "regulation and control" of a [British] Consul who would reside in Bangkok.[25] The role of the Consul was to abide by all of the provisions of the Treaty and enforce its observance by British subjects. This included abiding by all rules and regulations enacted for the "government of British subjects in Siam, the conduct of their trade, and for the prevention of violation of the laws of Siam". Disputes between Siamese and British subjects were to be "heard and determined by the Consul in conjunction with the proper Siamese officers". Punishment of British subjects was to be determined by the Consul in accordance with British laws; punishment of Siamese subjects was to be determined by Siamese officers in accordance with Siamese law. The Consul was not to interfere in matters referring solely to Siamese nor do the Siamese interfere in questions which only concern British subjects.

Whilst British subjects were "permitted to trade freely in all the seaports of Siam" they were required to only reside in Bangkok or its environs (art IV).[26] They were able to rent land and build houses but were unable to buy land until they had been in Bangkok for 10 years. They were however able to buy or rent houses, lands or plantations within 24 hours of Bangkok "computed by the rate at which boats of the country can travel". The Consul would assist the possession process including the negotiation of the terms of rental or purchase. The property would be placed under the protection of the district authorities and the British subject would be subject to the same taxation regime as the Siamese. If cultivation or improvement of the land had not commenced within three years, the land was to be resumed by the local authorities and the original purchase price returned.

Import duties were set at 3% of the value of imported goods; payable in either kind or money at the option of the importer.[27] If the value of the goods was disputed, the Consul and the relevant Siamese official with an equal number of up to two merchants appointed as assessors by each.

Whilst opium was imported free of duty it could only be sold to an opium "farmer"; otherwise it would be confiscated.[28]

[24]Better known as the *Bowring Treaty*.
[25]Bowring Treaty 1855 art II.
[26]Ibid, art IV.
[27]Ibid, art VIII.
[28]Ibid.

Export tariffs were specified in a schedule to the treaty and were the same as those that applied to Siamese or Chinese vessels or junks and any further privileges applied to the Siamese and Chinese vessels would also apply to the British. The British merchants were able to carry out transactions directly with producers or purchasers without interference. Bullion and personal effects were allowed to be imported or exported free of duty.

If there was a scarcity of fish, rice or salt, the government of Siam reserved the right by public proclamation to prohibit the export of these items.

Finally, any privileges that may have been applied or might be granted by the Government of Siam to the Government or subjects of any other nation were to apply to the British Government and its subjects.[29]

Treaty of Amity and Commerce between Siam and the United States, 1833

The *Treaty of Commerce and Amity* was signed in Bangkok on 10 March 1833. Citizens from the United States were free to enter all ports in Siam and trade by buying and selling "on the terms and for the prices that the owners may see fit".[30] Munitions of war could only be sold to the King and opium was considered as contraband. The export of rice was prohibited.

In lieu of import and export duties, license fees or any other charges a measurement duty was imposed.[31] The duty was calculated on the breadth of the ship. If duties payable for foreign vessels were reduced in favour of any other nation the same would be applied to the vessels of the United States.[32]

If United States citizens coming to Siam for the purposes of trade entered into a debt with a local individual or a local owed a debt to a United States citizen, the debtor was obliged to sell all his goods to pay his debts. If the return from the sale of the goods was insufficient to satisfy the debt the remainder of the debt was forgiven without further punishment.[33]

Merchants wishing to rent houses were required to rent factories [warehouses] owned by the King and pay the customary rent.[34] If goods were brought on shore no duty was to be levied.

The merchants of the United States were required to respect and follow the laws and customs of Siam "in all points".[35]

Finally, if a foreign nation other than Portugal [which already had a Consul in Siam] was given permission to post a resident Consul to Siam then the United States had the liberty to do the same.[36]

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[29]Ibid, art X.
[30]Treaty of Amity art II.
[31]Ibid art III.
[32]Ibid art IV.
[33]Ibid art VI
[34]Ibid art VII
[35]Ibid art IX.
[36]Ibid art X.

Thailand Revises the Treaties with Foreign Countries 1919 – 1926

In the late 1800s Thailand reorganised its administration and eradicated the need for extraterritoriality.[37] Extraterritorial rights imposed two obstacles in the eyes of the Siamese, namely consular jurisdiction and the fixing of duties. The earlier treaties permitted amendment but not renouncement, so negotiations took many years. The new treaties contained two main points: consular jurisdiction was terminated with foreign nationals coming under the jurisdiction of Thai courts and Thailand was free to set its own tariffs.

The Bowring Treaty was superseded by the *General Treaty of Friendship with Great Britain, 1925* and the *Treaty of Commerce and Navigation with the Great Britain, 1925.*

The *Treaty of Amity and Commerce* was superseded by the *Treaty of Friendship, Commerce and Navigation with the United States, 1920*. During the height of the Vietnam War Thailand and the United States entered into a new treaty.

U.S. - Thailand Treaty of Amity and Economic Relations, 1966

The *Treaty of Amity and Economic Relations between the Kingdom of Thailand and the United States of America* was signed at Bangkok on 29 May 1966.

The Treaty allowed nationals of either party to enter the territory of the other party to carry out trade or develop or direct the operations of an enterprise in which they have invested[38] and have the full protection of the law of that party (art I(2))[39]. In most activities the concept of national treatment applied in that they were have the same privileges as the nationals in whose country they were operating.[40] Parties were prohibited or restricted in participating in enterprises involved in "communications, transport, fiduciary functions, banking involving depository functions, the exploitation of land, or other natural resources, or domestic trade in indigenous agricultural products".[41] In addition, the parties reserved the right to grant special privileges: to the products of its national fisheries; adjacent countries in order to encourage border trade; and, members of a customs union or free trade area to which it may become a member.[42] State-owned enterprises from each party were to make their sales and purchases to the other party based on commercial considerations; nationals, companies and commerce of such other party shall have equal opportunity to compete.[43] Import and export controls could be placed trade in gold or silver: fissionable materials;

[37]Ministry of Foreign Affairs 2015.
[38]*Treaty of Amity and Economic Relations, 1966* art I (1).
[39]Ibid art I(2)
[40]Ibid. For instance art II, art III, art IV and art V.
[41]Ibid art IV(2).
[42]Ibid art VIII(6).
[43]Ibid art XI(1).

arms, ammunition and implements of war.[44] Finally, disputes between the parties were to be settled by arbitration.[45]

Thailand since 1995

Since around 1995, the year Thailand joined the World Trade Organization (WTO) as a founding member, Thailand has become very proactive in both protecting and furthering its interests in the international arena. Three case studies which follow show Thailand's capacity and capability albeit that there have been some miscalculations on the way.

Free & Fair Trade

Thailand has been active in protecting its economic interests from that time. As on 1 August 2019, for instance, Thailand was a party to 14 WTO disputes as complainant, four as respondent and 93 as a third party.[46] All four complaints against Thailand were in relation to violation of the anti-dumping provisions of Art VI of the General Agreement on Tariffs and Trade 1994. Thailand was also a party as complainant in anti-dumping cases.

Poland versus Thailand

Poland lodged a complaint against Thailand's application of antidumping measures in relation to steel products from Poland.[47] The Panel and Appellant Body found that Thailand's application of antidumping provisions was inconsistent with the *Agreement on Implementation of Article VI of the General Agreement on Tariffs and Trade 1994*. Thailand had not evaluated all of the fifteen factors listed in Art 3.4 of the Agreement to determine the impact of the dumped imports on the domestic industry.

Thailand and others versus the United States

At the end of 2000, Thailand together with Australia, Brazil, Chile, European Communities, India, Indonesia, Japan, and Korea lodged a complaint against United States' application of the *Continued Dumping and Subsidy Offset Act* of 2000.[48] The Panel and Appellant Body found that the Act was inconsistent with the Agreement, but the matter finally went to arbitration and the USA was given 11 months to conform. After further negotiation Australia, Indonesia and Thailand agreed to allow the USA a further 12 months to conform. Eventually on 8 February 2008 the USA passed into Law the *Deficit Reduction Act* which was claimed to bring the USA in full conformity with its WTO obligations. The

[44]Ibid art XII(1).
[45]Ibid art XIII(2).
[46]World Trade Organization 2019.
[47]World Trade Organization 2010a.
[48]World Trade Organization (2018).

complainants welcomed the legislation but did not consider that the changes were fully in conformity with the Agreement.

Thailand versus the United States

Thailand lodged a complaint against the action involving USA's application of antidumping measures on frozen warm-water prawn/shrimp from Thailand.[49] The Panel and Appellant Body found that the actions of the USA were inconsistent with the Agreement and Thailand allowed the USA time to comply. Thailand also lodged a complaint against the USA's application of anti-dumping measures on Polyethylene Retail Carrier Bags from Thailand. The Panel and Appellant Body found that the actions of the USA were inconsistent with the *Agreement on Implementation of Article VI*. Again, Thailand allowed the USA time to comply.

Summary

These cases show that Thailand is capable of defending its exporters against the USA's application of anti-dumping laws that are inconsistent with the Agreement. In addition, Thailand as an active participant in the operations of the WTO is regularly reserving its rights to Dispute Settlement proceedings where the application of any decision to parties other than those in dispute may impinge on its economy.

Trade Negotiations

Thailand has successfully negotiated nine free trade agreements.[50] Of these eight are bilateral with the ninth being that with the other nine members of Association of South East Asian Nations (ASEAN). It is in the process of negotiations for another eight bilateral or multilateral agreements. In addition, as member of ASEAN, Thailand is a party to an additional six multilateral free trade agreements. Finally, as part of the sixteen-member ASEAN+6 Group it is negotiating the Regional Comprehensive Economic Partnership, or RCEP.

This is quite an impressive record for a developing country.

Thailand is also willing to stand up to its trading partners and say "No deal" when it considered that an agreement would be contrary to its interests. Such was the case when it was asked by the United States to be part of the negotiations for the Trans Pacific Partnership (TPP).

Whilst advocates saw benefits in becoming part of the push for regional economic integration the opponents were very concerned about the potential adverse effects on Thailand of tighter rules on intellectual property rights and patent registration as well as the potential loss of sovereignty.[51]

In the end, the Government's severe reservations about the advantages of joining resulted in it declining to enter the negotiations. This was partly driven

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[49]World Trade Organization (2010b).
[50]Asian Development Bank (2019).
[51]Yoon (2012).

by domestic political factors and higher prices for drugs and pharmaceuticals.[52] There were also concerns about the potential impact on Thailand of enhanced labour and environmental requirements as well as liberalizing the services sector. Another major factor may have been the rule that "nothing is agreed until everything is agreed" which requires the parties to accept all of the TPP clauses.[53] The final TPP agreement has a significant number of caveats and party to party agreements.[54] In the end it is likely that Thailand did not join the negotiations because of the delay caused by the continuing distraction of the political crisis. When Thailand had decided the TPP might be a good idea it was too late.[55] If Thailand had joined the negotiations it could have used its participation to drive a proposal and bargain in some sensitive issues that are current concerns. On the withdrawal of the United States the other eleven TPP signatories negotiated the *Comprehensive and Progressive Agreement for Trans-Pacific Partnership*[56] which uses the TPP as its basis but with some of the most contentious clauses removed and subject to further negotiation. The final outcome justifies the opinion of the first author that Thailand should have been part of the original negotiations and would have been able to influence the outcome especially with the help of the ASEAN countries who were part of the TPP negotiations.[57]

Discussion

Since the time of Thailand's early treaties there has been a drastic change in the way conflicts between countries have been resolved. The use or armed force has given way to negotiation. At the same time a rules-based international trading system has developed under the World Trade Organization.

This has allowed a relatively small country like Thailand to use the international trading rules to defend its industries against unfair actions of others. As described earlier this has allowed Thailand and others to take on the largest international economy, the United States, in the WTO and win. This

[52] Limsamarnphum (2015).

[53] This was the common understanding of parliamentary officials with whom the first author was working at the time.

[54] *Trans Pacific Partnership Agreement between the Government of Australia and the Governments of: Brunei Darussalam, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, the United States of America and Vietnam signed 4 February 2016 (not yet in force) [2016] ATNIF 2.*

[55] The dangers of not being part of the negotiations early can be summed up by reference to Canada. Canada in 2005 rejected the opportunity to join preliminary discussions. When Canada wished to join the negotiations, its prospective partners were required to determine Canada's suitability to join negotiations already in progress. At least two parties, USA and New Zealand had at the time, trade issues with Canada. New Zealand was opposed to Canada's attempts to maintain existing dairy supply management. In 2010, USA officials declined to support Canada's case. They were finally accepted as parties in 2012 (Dawson (2012)).

[56] *Comprehensive and Progressive Agreement for Trans-Pacific Partnership* signed 8 March 2018 (entered into force 30 December 2018).

[57] Smith (2015).

resulted in the withdrawal of the United States *Continued Dumping and Subsidy Offset Act of 2000*.

Of course, Thailand's action is not always successful as was the case in its first Investor State Dispute Settlement arbitration defence against Walter Bau. Initially Thailand considered that international arbitration was a threat to its sovereignty. However, following the debacle surrounding the Walter Bau Investor State Dispute Settlement (ISDS) case where Thailand tried, but failed, to overturn the arbitration finding it has realised that arbitration of ISDS disputes is not necessarily the threat that was originally perceived.[58]

As noted by Smith and Smith an Australian mining company gave notice that it was preparing to commence arbitration proceedings against the Thai government over closure of its gold mine under the ISDS provisions of the *Thailand-Australia Free Trade Agreement* 2005.[59]

Rather than fight the case in the court of public opinion as happened in the Walter Bau case the response was measured. The government announced it had appointed a multi-agency committee to negotiate a settlement in the country's best interests and taking all stakeholders' interests into account.[60] Most importantly he advised that the government was prepared to settle the dispute under the international arbitration process as sought by Kingsgate. He acknowledged that the process was in accordance with the bi-lateral agreement with Australia.[61]

A small nation like Thailand is no longer frightened of the armed power of powerful countries as it was in the past. As the world has changed these powerful countries, under pressure from the smaller nations, also changed their focus from armed force to negotiation. Nonetheless the powerful still use strategies such as blockades and imposing more stringent international rules to seek advantages over their trading partners.

Thailand has to be vigilant and not fall into such traps. Rather it must use the new rules to protect its sovereignty and economy as best it can.

Conclusions

Thailand has clearly learned from the past. Up until the early 20th Century Thailand was willing to trade land with France or allow the British extraterritoriality for what it saw as the major benefit – the preservation of its sovereignty.

Times have changed, and Thailand no longer has to make such trade-offs. Rather it uses the rule-based trading system to actively promote and protect its political and economic interests.

[58]Smith & Smith (2018).
[59]Ibid, at 287.
[60]Nation (2017).
[61]That is the Thailand Australia Free Trade Agreement (TAFTA).

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Agreements and Treaties

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Comprehensive and Progressive Agreement for Trans-Pacific Partnership signed 8 March 2018 (entered into force 30 December 2018).
General Agreement on Tariffs and Trade (GATT 1994), signed 15 April 1994 (entered into force 1 January 1995).
General Treaty of Friendship with Great Britain, 1925.
Thailand-Australia Free Trade Agreement signed 5 July 2004 (entered into force 1 January 2005) [2005] ATS 2 (TAFTA).
Trans Pacific Partnership Agreement between the Government of Australia and the Governments of: Brunei Darussalam, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, the United States of America and Vietnam signed 4 February 2016 (not yet in force) [2016] ATNIF 2.
Treaty of Amity and Commerce signed on 10 March 1833.
Treaty of Amity and Economic Relations between the Kingdom of Thailand and the United States of America signed 29 May 1966.
Treaty of Commerce and Navigation with the Great Britain, 1925.
Treaty of Friendship, Commerce and Navigation with the United States, 1920.

Acts

Continued Dumping and Subsidy Offset Act (CDSOA), 2000.
Deficit Reduction Act, 42 USC, 2006.
Thailand-Australia Free Trade Agreement, 2005

Transfer of Corporate Seat in EU: Recent Developments

By Dubravka Aksamovic[*]

Transfer of corporate seat has been important legal topic in EU law ever since 1980's. While it was clear from the wording of the very first EEC treaties, that companies should benefit from a freedom to establish themselves in another Member State, the extent of this freedom was, more or less, unclear. Some useful guidance with regard to the issue when and under what circumstances a company can transfer its corporate seat and its activities to another Member State, have been given by the ECJ. Every new Court's decision regarding transfer of corporate seat (such as ECJ decisions in case Centros, Inspire Art, Überseering, Daily Mail, Cartesio) had huge echo among corporate lawyers and business and were analysed in the smallest details. The most recent ECJ decision in Polbud case again showed that transfer of corporate seat is topic that still raises number of legal questions. In that sense, paper will analyse relevant EU legislation applicable to corporate mobility. It will particularly focus on new proposal of the Directive 2017/1132 on cross-border conversion, mergers and divisions and possible impacts of that Directive to corporate mobility. Special attention will be given to the ECJ ruling in Polbud case in which ECJ had to decide on delicate question as to whether or not companies should be allowed to "change nationality".

Keywords: *Companies, Mobility Transfer of Corporate Seat; Directive on Cross Border Conversion; Mergers and Divisions.*

Introduction

The idea of free movement of companies on the internal market is not new. Free movement of companies is clearly given Treaty right[1]. Yet, more than a quarter of century after the ECJ rulings in *Daily Mail*[2] and *Centros*[3], some of the first prominent EJC decision concerning corporate mobility, and after numerous EU Commissions attempts to provide systematic solution on the problem of corporate mobility, cross-border mobility of companies remains unresolved issue. Moreover, large number of EU countries still show great level of hostility towards companies' migration and do not allow companies to move abroad through process of conversion or any other way, without previously being dissolved in country of origin. As a result, companies wishing to move to another Member state, although

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[1]Article 49 and 54 of the TFEU guarantee freedom of establishment of all companies and firms.

[2]*The Queen v H. M. Treasury and Commissioners of Inland Revenue, ex parte Daily Mail and General Trust plc.* Case 81/87. European Court Reports 1988 -05483. ECLI identifier: ECLI: EU:C:1988:456

[3]*Centrols Ltd and Erhvervs-og Selskabsstyrelsen,* Case C212/97, ECR, I-1459. Judgement of 9 March 1999.

cannot be absolutely prevented from right to move, face financial, administrative and legal obstacles. Such situation has negative impact on EU integration and jeopardises basic ideas on which EU was built upon.

This legal issue itself would not be so controversial if, beyond the technical discussion, there were no important political and economic interests at stake[4]. Under the current Member States legal regime, all cross-border operations are rather costly. According to the estimations provided in Study on the cross-border transfers of registered office and cross-border division of companies[5] a cross-border transfer of registered office costs in average at EU level, between 20,000 and 40,000 euros, while for example a cross-border division costs in average at EU level, between 55,000 and 70,000 euros per operation[6]. These costs vary from state to state and they depend on the type and size of company, hosting and home country, current procedures, and registration fees[7]. These costs are typically associated with the attorney's fees, costs related to the execution of the transfer (production of documents, organisation of general meeting, etc.) and registration costs[8].

However, statistical data provided in the second report on Cross-border Mobility in the EU[9] shows that despite numerous obstacles and high costs associated with the transfer of corporate seat through merger or otherwise, number of European companies moving from one Member State to another is in constant increase. Accordingly, in four year period, from 2008 to 2012 there were totally 1227 transactions that have resulted in transfer of corporate seat, what is approximately 306 transactions annually, while in five years period from 2013 until 2018 there were totally 1936 transactions that have resulted in transfer of corporate seat, or approximately 387 transactions annually[10]. As we can see, on annual level number of transactions increased for almost 25%. That is not negligible number. Those figures should be taken seriously. They also oblige EU to act and to provide for a workable solution for those companies who wish to move from one Member State to another.

So far, EU Commission's attempts to regulate analysed issue brought only partial success despite the fact that EU got overwhelming support for enactment of legal instrument which would regulate cross border mobility of companies[11].

For example, in 2004 the Commission conducted public consultation on the Future of EU company law where significant majority of 68% of the consultation participants were *in favour* of enacting directive that would regulate cross border transfer of companies' seat[12]. Then again, the Commission carried out several public consultations in 2012, 2013, 2015 and 2017 asking all interested stakeholders

[4]Wymeersch (2003) at 4.
[5]Ernst &Young (2018).
[6]Ibid, at 25 and 29.
[7]Ibid, at 25.
[8]Ibid, at 25.
[9]Biermeyer & Meyer (2018a).
[10]Ibid, at 5-7.
[11]EAVA (3/2012). See also Cross-border transfer of company seats European Parliament resolution (2012) at 18-23.
[12]EAVA (2012) at 23.

whether regulation of cross-border migration of companies is needed[13]. The majority of respondent supported Commission's initiative to adopt regulation which would enable simple, transparent and cost-effective relocation of company from one Member State to another. However, despite incontestable support to the Commission and Commission's really intensive legislative activities, we still do not see the end and final outcome of all those efforts. An issue on companies' migration on EU level looks like a never-ending story. In that sense, in lines that follow author will firstly give brief overview on the most relevant EU documents dealing with companies' migration. Special attention will be given to the most recent developments.

Transfer of Corporate Seat- Old Story with New Beginning or a Never Ending Story?

The issue on corporate mobility on EU level is as old as EU, although this topic didn't gain much public attention before 1990'. Many would agree that problem of companies mobility came in public focus after the ECJ decision, firstly in Daily Mail in 1988, and then again in Centros case in 1999. Since then, an interest for this topic was quite uneven, sometimes is increasing, usually after some ECJ decision, and then again, it was decreasing. Things started to change after year 2000, when discussions on corporate mobility has become a hot topic[14].

First Commission's serious attempt[15] to address the problem of corporate mobility came in form of proposal for the 14th Company Law Directive, Directive on the cross-border transfer of company's registered office or de fact head office to another Member State[16]. The first draft proposal was proposed by the Commission in 1997.[17] After several public consultations during early 2000's and despite clear EU Parliament position that such legislative instrument is welcomed and needed, EU Commission in 2007 decided not to make any legislative proposal and reserved the right to take further action with regard to the question of cross-border transfers of corporate seat[18]. If enacted, that Directive would prevent most

[13]See e.g. European Commission (2013). *Feedback Statement, Summary of Responses to the Public consultation on Cross-border transfers of registered office of companies,* September 2013, Ref. Ares (2016) 158996-12/01/2016.

[14]See e.g. Frost (2005); Lennarts (2008); Frada de Sousa (2009).

[15]With regard to analysed issue it should be mentioned that starting from early 70's EU produced several legislative acts which, directly or indirectly, addressed the problem of transfer of corporate seat. For example, in 1985 European Parliament adopted Regulation No 2137/85 on EEIG, than in 2001 in enacted Regulation No 2157/2001 on the Statute for European Company (commonly known as Societas Europea) and lastly in 2003 it enacted Regulation No 1435/2003 on the Statute for a European Cooperative Society. Although all three mentioned regulation deal with some aspects on corporate mobility, none of those documents were really enacted with the purpose to resolve open issues that occur in practice with regard to transfer of corporate seat or cross-border companies' migration.

[16]Cross-border transfer of company seats (2012) at 18-23.

[17]Proposal (1997).

[18]EAVA (2012) at 10.

of the problems that still occur in practice as a result of different Member State legislations and practices with regard to transfer of corporate seat[19].

However, there no signals from the Commission that it is likely that it will happen in near future. Nonetheless, although 14th Company Law Directive never came in force, it is not a document without any significance. Firstly, it prompted debates regarding companies mobility on EU level, it provided at least draft framework on the issue that it should be dealt with, and lastly, it made obvious that cross-border company mobility is no longer in the exclusive domain of national authorities[20].

On the other hand, unlike the Commission's attempts to regulate cross-border transfer of companies' seat, Commissions efforts in regulation of (cross-border) mergers were much more fruitful. Already in 1978 Directive 78/855/EEC concerning mergers of public limited liability companies[21] came into force. However, it should be emphasised that this Directive did not address the issue of cross-border mergers. Therefore, a crucial piece of legislation which would enable cross- border transfer of corporate seat through merger operations on EU level was missing all the way until year 2005 when EU Council and Parliament adopted Directive on Cross-border Mergers. This Directive has developed quite complex mechanism in respect to cross-border mergers and divisions[22]. It ushered in a new age for cross-border mergers[23]. Data show that after enactment of this Directive, merger activity has increased by 173%[24]. However, as anticipated, 2005 Merger Directive did not provide adequate legal solutions for all situations that emerged in cross-border merger practices. It was envisaged as a "living document" subject to review[25]. Accordingly, following comprehensive public consultations regarding existing barriers to cross-border operations and about the amendments that needed to be made to existing legislation, based on gathered information in 2017 Commission submitted a proposal for amending the 2005 Merger Directive. A new Directive (EU) 2017/1132 of the European Parliament and of the Council relating to certain aspects of company entered into force on 14 June 2017. Besides changes with regard to regulation of merger procedure, this Directive also codified several earlier Directives as a part of Company Law Modernisation Package[26]. Directive 2017/1132, among others, created a procedure for cross-border mergers and divisions of Limited Liability Company.

[19]According to the research provided by the DG Just in document called: Study on the cross-border transfers of registered office and cross-border divisions of companies, Member States legislation and practices with regard to the possibility of cross-border mergers, divisions or conversion significantly differ. Accordingly, specific national procedures in relation to cross-border transfers exist in Cyprus, Czech Republic, Denmark, Malta and Spain, while for example Member States that do not authorise the transfer of registered office are Croatia, Finland, Ireland, Lithuania, Romania and UK. See more at Ernst &Young (2018).
[20]Rammeloo (1999) at 110.
[21]Third Council Directive (1978) at 36-43.
[22]See Biermeyer & Meyer (2018b) at 4.
[23]Study on the Application on the Cross-Border Mergers Directive (2013) at 5.
[24]Ibid, at 5.
[25]This conclusion can be supported by the Article 18 of the 2005 Merger Directive which called for review of a Directive 5 years after final date of transposition.
[26]Proposal (2017).

However, this Directive did not last long. Less than a year after its enactment, the Commission submitted a new proposal to amend above mentioned Directive. It is significant that new Proposal came immediately after another EJC's milestone decision in so called Polbud case[27] what is not just pure coincidence. Paper will further highlight the basic features of Commission's Proposal on the Directive Cross-Border conversions, mergers and divisions.

New Proposal for a Directive Conversion, Mergers and Divisions- Objectives and General Approach

New Proposal on Directive as regards cross- border conversions, mergers and divisions is rather complex and somewhat unsystematic legal document. It is surprisingly large document[28], particularly in light of the fact that the issue of cross-border mergers and divisions have been previously regulated by earlier Directive and that, in that sense, the proposed text is not a new directive, but just an amendment to an existing one.

If we look at the structure of the Proposal, it is noticeable that the Proposal consists of few parts. It starts with a lengthy explanatory memorandum, where Commission provides reasons for and objectives of the Proposal. After this long introduction follows the central part of Proposal where in two chapters, Chapter I and Chapter IV, Commission proposes regulatory framework for three different types of cross-border business operations, cross-border conversion (article 86a to 86u), cross- border mergers, and cross-border divisions (article 160a to 160w).

While with regard to cross-border mergers, Proposal only improves and updates already existing rules of the Directive 2017/1132, with regard to cross-border conversions and cross-divisions Proposal introduces completely new rules. When (and if) new Proposal is adopted, a whole spectrum of cross-border legal operations will be offered to the European companies aspiring to move from one Member State to another Member State in search for better business opportunity or more favourable business environment. In further text paper will present main features of two new cross-border business operations, cross-border conversions and cross-border divisions.

[27]Judgment of the Court (Grand Chamber) of 25 October 2017.Proceedings brought by Polbud - Wykonawstwo sp. z o.o. Request for a preliminary ruling from the Sąd Najwyższy.

[28]Proposal altogether has 127 pages. It contains very detailed 40 page long explanatory memorandum where Commission first provides for reasons and objectives of Proposal and then follows the text of proposed amendments to the current text of the Directive.

Cross-Border Conversions

Proposal regulates only cross-border conversions[29]. In that sense it should be emphasised that "domestic" conversions are out of the scope of Proposal. In the Proposal, a cross-border conversion is defined as "an operation whereby a company, without being dissolved, wound up or going into liquidation, converts the legal form under which it is registered in a departure Member State into a legal form of a company of a destination Member States, and transfers at least its registered office into destination Member State whilst retaining its legal personality"[30].

As we can conclude from above definition, main features of cross-border conversions are following: a) change of legal form, where a company established in accordance with the rules of one Member State converts in appropriate type of company of another Member State; b) transfer of economic activity, or /and registered office of converted company to destination Member State; c) converted company retains its legal personality since in case of conversion a company doesn't have to go through liquidation or other similar procedure in departure Member State. Although at the first glance it may seem that changes that occur in process of cross- border conversion are comparable to changes that occur in domestic conversion, a closer examination of domestic and cross-border conversion reveal that differences between these two conversions are significant.

Unlike domestic conversions, which do not bring radical changes to different stakeholders affected by conversion[31], in case of cross-border conversion, besides change of legal form, what is a common feature of domestic and cross-border conversions, a converted company also changes its "nationality". The fact that a company through a process of conversion changes its nationality means that the legal entity after conversion will be governed by a different company law regime. For employees that means that companies' employees shall become employees of a foreign company, for shareholders it means that their rights in the company after conversion shall be decided in accordance of the legislation of destination Member State, and for creditors it means that they will face a new legal regime, the one of the destination Member State.

Although it does not necessarily mean that their rights will be automatically reduced or seized, and they may even would be better or improved in case destination Member State applies higher legal standards with regard to shareholders, employees or creditors rights, still it may bring some legal uncertainty and creates fear as regards what future brings to them after conversion.

[29]Companies' conversion is one of many business restructuring operations. It is such legal operation where company changes its legal form and continues to exist as a company of different legal form, without being dissolved.

[30]Article 86b of the Proposal (2017).

[31]When conversion doesn't not include cross-border component it is not particularly intriguing operation. Except change of legal form, everything else stays more or less the same, employees keep their rights, and creditors automatically become creditors of converted company. There may be some differences with regard to ownership rights, but that issue will be resolved in process of conversion. Aksamovic, Simunovic & Kuna (2019).

This is mainly because of the fact that not all conversions are economically justified, but may be carried out with fraudulent intent[32].

Being aware of the fact that certain percentage of cross-border conversions are merely artificial constructions, the Commission pays in the Proposal special attention to the protection of employees, creditors and shareholders as well as to ex ante and ex post control of conversion procedure.

Conversion Procedure

Conversion procedure is in the Proposal fairly detailed regulated. It is envisaged as structured and multi- layered procedure which ensures a scrutiny of the legality of the cross-border conversion, firstly by the competent authority of the departure Member State, and secondly by the competent authority of the destination Member State[33]. The first step in the procedure would be the preparation of the draft terms of the cross- border conversion and two targeted reports addressed to shareholders and employees on the implications that the cross-border conversion will have[34]. Draft terms must be prepared by companies' management. It must contain all relevant information on proposed conversion based on which employees, creditors and other stakeholders will be able to determine how conversion will impact their position and rights[35]. Except for the stated purpose, specific value of the draft terms lays in the fact that it serves as a basis for the determination whether the intended cross-border conversion consitutes an artificial arrangement[36]. Besides preparing draft terms for conversion, management or administrative organ of the company will also have to prepare two separate reports explaining and justifying the legal and economic reasons for cross-border conversion. One report should be written for members of the company (shareholders) and the other on for the employees.[37] In order to avoid abuses of accuracy of information provided in the draft terms and reports, Proposal prescribes that draft terms and reports have to be examined by an independent expert[38]. Examination by an independent expert serves as an assistance to the competent authority of the departure MS to make a correct decision as to whether or not to issue the pre-conversion certificate on cross-border conversion[39].

During the conversion proceedings, both mentioned documents have to be approved by the General Assembly before they are submitted, first, to the

[32]One of the biggest concerns associated with cross-border companies' migration is as to whether cross-border operation constitutes artificial arrangements. See, e.g. Cerioni (2010); Biermeyer & Meyer (2018b).
[33]Proposal (2017) at 6.
[34]Ibid.
[35]Aksamovic, Simunovic & Kuna (2019).
[36]Ibid.
[37]Art. 86e of the Proposal¸ Rec. 11 and 12, Art 86e(1) and 86f(1) of the Proposal; e.g. see Mörsdorf (2019) at 145.
[38]Aksamovic, Simunovic & Kuna (2019).
[39]Rec. 13 of the Proposal. Independent experts are appointed by the competent authority of the departure MS. Art 86g (2) the competent authority of the departure MS appoints individual expert within 5 working days from the application for examination.

competent authority of departure Member State which is responsible to decide whether to issue a pre-conversion certificate or not[40]. If after detailed scrutiny, the pre-conversion certificate is issued, it would be transmitted without delay to the competent authority of destination Member State. Destination Member State must carry out a scrutiny as regards that part of the procedure which is governed by the law of destination Member State and it must check whether converted company complies with provisions of its national law on the incorporation of companies. When all checks are done and if all requirements are met, a company would be registered in the register of a Member State of destination and de-registered in the register of the Member State of departure[41]. From the moment of registration in the destination Member State, conversion becomes legally effective. From that moment a company gets new "nationality" and becomes a company of a destination Member States, what can, as already said, cause fears and doubts as regards to the rights of employees, creditors or shareholders.

Employees, Creditors and Shareholders Rights

The Commission's concern for employees, creditors and shareholders rights is more than obvious. In the Proposal, Commission repeatedly emphasise that the main objectives of the harmonised rules for cross-border conversions are two-fold:

- enabling companies, particularly micro and small, to convert in an orderly, efficiently and effective manner, and
- protecting the most affected stakeholders such as employees, creditors and shareholders in a suitable and proportionate manner[42].

Since detailed analysis of all rights granted to employees, creditors and shareholders is beyond the scope of this paper, here are few examples of the most important rights given shareholders, employees and creditors.

Quite expectedly, the largest number of rights relates to shareholders rights. Firstly, conversion procedure must be approved by shareholders at the General Assembly meeting. Before meeting, shareholders must be given a right to comment on draft term and to propose changes. They can also submit comments to the company and independent expert what may influence independent expert final report. Proposal doesn't prescribe required majority of shareholders for reaching the decision on conversion, however, it prescribes that all shareholders who voted against conversion have right to cash compensation. This right is also extended to shareholders who did not vote at all. Quite unusually, the Proposal prescribes that shareholders who decided to exit company and who accepted cash compensation have right to challenge the calculation of the amount of cash compensation before

[40]Proposal (2017) at 8.
[41]Ibid.
[42]Proposal (2017) at.12.

national court within one month of the acceptance of the offer.[43] It is interesting that this opportunity is given to members even though they accepted the offer[44].

With regard to the creditors, they are also protected in various ways, since there is a risk that their interests will be adversely affected by the conversion, in particular, by being henceforth subject to less stringent rules in relation to capital protection and liability.[45]For example, creditors, who find that their interests in the conversion are not sufficiently or adequately protected have right on administrative or judicial protection of their rights within one month of the disclosure.[46] Moreover, Proposal also predicts that the Member States may require that the management of the company provide a declaration of accuracy reflecting the financial status of the company as a part of draft terms[47]. Creditors can also submit comments on draft terms and independent expert report to the company as well as to the competent authority[48].

And lastly, the Proposal also prescribes mandatory employees participation in the company carrying out a conversion and provides mechanisms for protection of employees, since their rights are put at risk by the conversion procedure. In the first place, the rules on employee participation of destination MS applies must been followed, unless the rules of departure MS provides the same level of protection[49].

Cross-border Divisions

Besides cross-border conversion, Proposal further introduces a new legal framework for cross-border divisions. So far, EU legislation captured only rules on "domestic" divisions. Sixth Company Law Directive dealt with division of Limited Liability Company[50]; however rules on that Directive were inapplicable to cross-border divisions. Company division can typically take one out of two main forms, first is division by acquisition, and second is division by formation of a new company. Proposal regulates only division by formation of new company. Such approach is criticised as insufficient and unjustified, particularly because of that fact that cross-border divisions were already possible based on Treaties rules and ECJ rulings. According to the EJC decisions in Sevic[51], Cartesio[52] and Vale[53], companies are allowed to enjoy a right to participate in cross-border division

[43]Art 86j (5) of the Proposal.
[44]Aksamovic, Simunovic & Kuna (2019).
[45]Horak & Dumančić (2017) at 725.
[46]Article 86k (2) of the Proposal.
[47]Article 86k of the Proposal.
[48]Article 86h of the Proposal.
[49]Aksamovic, Simunovic & Kuna (2019). See also: Art 86f and 86l (1) and (2) of the Proposal.
[50]Sixth Council Directive 82/891/EEC of 17 December 1982 based on Article 54 (3) (g) of the Treaty, concerning the division of public limited liability companies, OJ L 378, 31.12.1982, p. 47–54.
[51]Sevic Systems AG, C-411/03, 13 December 2005.
[52]Cartesio Oktato és Szolgáltato bt, C-210/06, 16 December 2008.
[53]VALE Epitéci kft, C-378/10, 12 July 2012.

within a Member State to the same extent that the division is accepted by that Member State in its national law. However, despite this Court's attitude, in all EU countries which do not have explicit rules for cross-border conversion, and great majority of EU Member States don't have rules on cross-border division[54], cross-border division of a company is either impossible, or if it is possible through indirect procedures[55], than, it is extremely difficult and expensive.

Therefore, with regard to cross-border division, Proposal also aims at introducing harmonised procedure for cross-border divisions. However it simultaneously pays significant attention, as in case of cross-border conversion, to shareholders, creditors and employees rights.

Provisions relating to the procedure of cross-border divisions are largely inspired by the existing framework for cross-border mergers and cross-border conversions. Given the similar risks inherent to cross-border divisions as to cross-border conversions, the structured and multi-layered procedure as proposed for conversion would also be required for divisions[56]. The procedure for cross-border division follows closely existing one for cross-border conversion[57].The first step in the procedure is drawing up of the draft terms and external experts report, disclosure of those documents to employees, creditors and shareholders, shareholders' approval at the General Assembly, examination of documents by the competent authority of the Member State of departure and then of the competent authority of the destination Member State. Last step is registration of the company in destination Member State.

Whilst the procedure of the division is largely similar to the procedure of conversion, situation is a bit different with regards to the rights of creditors, shareholders and employees. When a company divides itself into one or more companies, the creditors, employees and shareholders of the company will want to know whether they will be creditors, employees or shareholders in new company, formed by division or they will retain their rights and position in "old" company[58]. Creditors may particularly be concerned about financial stability and sustainability of new company which will have to pay debts when they become due[59], while shareholder will be concerned whether after division the shares in a new company will worth less that shares in "old company". As regards to the employees, it is obvious that for some employees, notably for those who will continue to work in "old company", nothing will change after division. They will continue to work in same company and in the same country. On the other hand, some employees will be transferred in new company formed by division and they will face same consequences, risks and fears as employees in case of companies' conversion.

Abovementioned issues clearly indicate that with regard to protection of shareholders, employees and creditors rights, Proposal cannot follow identical

[54]Cross-border division are explicitly permitted only in the laws of Czech Republic, Denmark and Netherlands. Study on the cross-border transfers of registered office and cross-border divisions of companies, Ernst &Young (2018) at 40 and 72.
[55]Ibid, at 73.
[56]Proposal (2017) at.11.
[57]Alvarez (2018).
[58]Knapp (2018).
[59]Ibid.

approach as in case of cross-border conversion. Here are few examples of rules that Proposal prescribes in cross-border divisions and which are non-existent in regulation of conversion.

So, with regard to creditors, Proposal prescribes that when creditors claim is transferred to a recipient company, and if a creditor cannot obtain satisfaction form that recipient company, recipient company and divided company shall be jointly liable for that obligation[60], even if such protection is not established under the national, Member State rules. Proposal further prescribes that all directors of dividing company have to make a declaration of solvency. In this declaration they will have to confirm that they are unaware of any reason why the dividing company and the recipient company will be unable to meet their liabilities when they fall due[61].

With regard to employees, Article 160n deals with the participation of employees in management or supervisory boards. In principle, it prescribes that the employee participation in the recipient companies would have to follow the respective Member State rules, unless the national laws of Member State doesn't provide for same level of the employee participation in the company's management or supervisory organs as existing in the company being divided[62]. In case that as a result of national Member State rules number of employees in the company's management or supervisory organs decrease, the company will have to enter into negotiations with the employees to determine their participation in the recipient company. Such negotiations are obligatory[63]. Moreover, Proposal prescribes that recipient company will have to preserve at least for three years in substance the employees' participation rights in case of subsequent operations like mergers, divisions or conversions[64].

Article 160l provides for safeguards for shareholders. With regard to share-holders, differences in regulation of cross- border conversion and cross- border divisions are lesser. Like in case of cross-border conversion, in case of cross-border division shareholders are entitled to vote on draft terms, to suggest changes, to comment on the draft terms and lastly they are also entitled to exit rights and cash compensation. Members who want to keep their rights in the company can challenge the share exchange ratio which was suggested and explained in draft terms[65].

European Court of Justice – A Driving Force of EU Integration and Free Movement of Companies

Commission's political battle for free movement of companies on European level would not have been possible without strong support of ECJ. Some authors

[60]Article 160m of the Proposal.
[61]Knapp (2018).
[62]Proposal (2017) at 40.
[63]Proposal (2017) at 40.
[64]Proposal (2017) at 40.
[65]Article 160g of the Proposal.

stress that "the biggest boost for companies' mobility did not come from the Commission, but from that other powerful EU institution, the European Court of Justice"[66]. Irrespectively as to whether we agree or disagree with above statement, it is undisputed that many obstacles and barriers to cross-border mobility have been removed by ECJ, much before the Commission have finally reached political consensus on certain sensitive issue. This is definitely true as regards cross-border conversions. A Proposal for a Directive as regards cross-border conversions, mergers and divisions is Commission's reaction to ECJ decision[67] in Polbud case[68]. However, although Polbud case may have been a trigger to regulation of cross-border conversions and cross-border divisions on EU level, it is just one of many the ECJ's milestone decisions on the freedom of establishment. A number of earlier ECJ decisions, such as Centros, Inspire Art, Daily Mail, Vale and other pawed the way to Court's decision in Polbud.

Polbud Case: Just another EJC Decision or a Step Closer to Final Solution for Companies' Migration?

Polbud case concerns Polish company who decided to transfer its registered office to Luxemburg. Decision on transfer of company's registered office was brought by a resolution of extraordinary general meeting which took place on 30 September 2011. On the basis of that resolution, Polbud lodged a request for opening of a liquidation procedure in Polish commercial register. In 2013 Polbud transferred its registered office to Luxembourg and become Consoil Geothechnik Sarl. Following the transfer of registered office to Luxembourg, Polbud lodged an application at the Polish registry requesting its removal from Polish commercial register. The reason stated for the application was the transfer of the company's registered office to Luxembourg. The registry requested from Polbud to submit number of documents which a regularly required in case of winding up procedure. Polbud claimed that it this request is legally unfounded because it was not being wound up and because company continued to exist as a company incorporated under Luxembourg law. The Court did not accept Polbud's arguments and it refused Polbud's application for removal on the ground that the abovementioned documents have not been submitted[69]. Against that decision Polbud brought an action before national courts, firstly to the competent District Court and then an appeal to the competent Regional Court. In those proceedings, Polbud claimed that compliance with the requirements of the mandatory liquidation procedure laid down under Polish law was neither necessary nor possible, since it had not lost its legal personality[70]. Both Polish courts dismissed the action[71]. The third referring

[66]Lennarts (2008) at 1.
[67]See Frazzani, Angelici,, Hoffmann, MmedicI & Sciaudone (2018) at 25
[68]Polbud - Wykonawstwo sp. z o.o.,C-106/16, 25 October 2017.
[69]Poblud, points 7- 13 of the Judgement.
[70]Frazzani, Angelici, Hoffmann, MmedicI & Sciaudone (2018) points 7-13 of the Judgement.
[71]Rammeloo (2018) at 89.

Polish court, the Supreme Court of Poland, decided to stay the proceeding and to refer following questions to the ECJ for a preliminary ruling[72].

Firstly, the Polish Supreme Court asked whether freedom of establishment applies to the transfer of registered office, when there is no change in location of its real head office and when company incorporated under the law of one Member State converts to a company of another Member State.

Secondly, the Polish Supreme Court asked whether national rules which prescribe that removal from the commercial register is possible only after mandatory winding up procedure are contrary to the freedom of establishment.

In short, on those questions the ECJ gave following answers. The EJC said that the transfer of the registered office of a company, where there is no change in location of real heads office, falls within the scope of freedom of establishment protected by EU Law[73]. Moreover, it said that it is not necessary for the company to pursue a "real business" in the Member State where it transfers its registered office[74].

With regard to second question, the ECJ held that Polish legislation which require mandatory liquidation of a company that wishes to transfer their registered office to another member State constitutes a restriction on freedom of establishment. With regard to that, the EJC also said that, while both Member States, of departure and of arrival may impose certain requirements, no unjustified restrictions can be imposed, even when the same are apt as protecting primarily interests such as protection of workers, creditors and shareholders[75]. For the end, the EJC concluded that a general requirement of winding-up a company before carrying out a cross-border conversion is an unjustified restriction to the freedom of establishment, and is not proportionate to the extent to attain shareholders, creditors and worker's protection[76].

As we can see, in Polbud judgement the ECJ once again confirmed its general position that EU companies should not be prevented from right to move from one Member State to another and thus deprived from the right on the freedom of establishment. Innovative element in this decision, compared to Court's previous decisions, lies in the fact that it extended freedom of establishment on the situation of transfer of corporate seat without transfer of "real business". However, the special merits of Polbud and other ECJ decisions on companies' migration do not solely lay in the context of particular Court's ruling. Although every new Court's decision created another breakthrough in the domain freedom of establishment, the more important is political message that is send by the ECJ. Nonetheless, we all must be aware of Court's limitations. The Court itself cannot fill all loopholes in EU law or remove all contradictions that exist in the national laws of Member States. The Power of removing those obstacles lies in the hands of European Commission and European Parliament.

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[72]Frazzani, Angelici, Hoffmann, MmedicI & Sciaudone (2018) point 18 of the Judgement.
[73]Frazzani, Angelici, Hoffmann, MmedicI & Sciaudone (2018) at10.
[74]Frazzani, Angelici, Hoffmann, MmedicI & Sciaudone (2018) at.10.
[75]Ibid, at 10.
[76]Ibid, at 14.

Conclusion

Paper provides for a critical insight in the most recent developments regarding companies' migration in the EU. It examines major novelties in the new Commission's Proposal for a Directive as regards cross-border conversions, mergers and divisions. It describes political and economic context in which EU rules on companies' migration evolved as well as role of the ECJ in those processes.

Special attention is given to the Proposal's rules on cross-border conversions and cross-border divisions, in particularly rules that relate to the procedure of cross-border conversion and cross-border division. It also focuses on some of the most relevant issues regarding rights of shareholders, employees and creditors. Although paper doesn't go into detailed and deeper analysis of proposed legal solutions, the general impression is that the proposed procedure for cross-border conversion and cross- border division is quite robust and complicated and that there is a need for improvements and convergence of rules related to shareholders, employees and creditors rights.

Nonetheless, this doesn't bring into question necessity of enacting Proposal for a Directive as regards cross-border conversions, mergers and divisions. It is unquestionable as to whether such legal instrument is desirable or not. The new rules on cross-border conversions and cross-border divisions are huge step towards (finally) harmonised legal framework for cross- border business operations resulting with companies' migration.

If the Proposal eventually gets accepted, in proposed form or in improved form, procedure of companies' migration on EU level will be more harmonised, accelerated and hopefully cheaper.

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What Effect Does European Private International Law on Cross-border Divorce Have on National Family Laws and International Obligations of the Member States?

By Līga Stikāne[*]

With the number of cross-border divorces in the EU soaring, the adoption of the 'Brussels II bis Regulation' and of the 'Rome III Regulation' seems like a logical step. Yet, discussion-provoking is the fact that the interaction between Brussels II bis and Rome III has resulted in Malta being forced to introduce the institution of divorce into its substantive family law. This shows that EU law may have some impact on the national family laws of the Member States in the future as well. For instance, Member States which have not yet legalised same-sex marriages may eventually be forced to do so. This paper argues why this acknowledgment is especially confirmed by Article 13 of Rome III. Besides, a Member State which participates in Rome III, but whose law does not provide for the institution of legal separation may be forced to deal with this institution. Moreover, although by using the public policy rule Member States may avoid the recognition of a Muslim divorce pronounced in a third country, problematic issues may be caused by the mufti divorce pronounced in Greece, which according to Brussels II bis could be entitled to an automatic recognition in the other Member States. Furthermore, this contribution suggests that, if according to Brussels II bis Greece automatically recognises a cross-border divorce of a Greek Muslim couple from Western Thrace with a habitual residence in, for instance, France, to which French law has been applied instead of the Sharia, Greece breaches its international obligations. Thus, this paper argues that the application of European private international law may create an awkward situation, in which a Member State may be forced to breach its international obligations in order to fulfil its obligations under EU law. Therefore, this contribution suggests an amendment to Article 22 of Brussels II bis.

Keywords: *European private international law, conflict-of-laws, cross-border divorce, Brussels II bis, Rome III.*

Introduction

For centuries there was a huge social stigma attached to divorce, which historically was mainly caused by the well-known negative attitude of the Roman Catholic Church towards the dissolution of marriage. If initially in Ancient Greece and Ancient Rome divorce was allowed, the situation dramatically changed during the medieval times when after the fall of the Western Roman Empire the canon law of the Roman Catholic Church determined the way of life for Europeans, for the first time in the history of Western civilisation also regulating the celebration

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and termination of marriage in detail. One of the main postulates of the canon law was a never before experienced complete abolition of the institution of divorce which, according to the opinion of prominent Catholic theologians, follows from the dogma of the New Testament.[1]

The legal situation of divorce changed significantly from the 16th until the 18th century when under the influence of the Protestant Reformation and the Enlightenment more and more countries began to see marriage as a secular rather than a sacred institution. The first big change happened when many European countries introduced divorce in their secular family codes which were adopted as a result of the Enlightenment. However, in these family codes the principle of fault was transferred from the religious institution of legal separation to the secular institution of divorce. Thus, at first it was possible to obtain a divorce only by proving the other spouse's fault in the breakdown of marriage. Therefore, the provisions of these family codes contained a number of so-called grounds for divorce which meant that divorce was a complicated and expensive process which was based on the principle of fault of one of the spouses.[2]

The second big change happened after World War II when the family law provisions on divorce were liberalised in many European countries and no-fault divorce was finally introduced. The institution of divorce experienced a very significant reform in the 1960s-1970s, when in many European countries divorce was allowed on the basis of an agreement between the spouses. Thus, divorce was not seen as a sanction that is applied to the guilty spouse anymore.[3]

The substantive family laws of all European Union (EU) Member States now provide for divorce. Since for various reasons a large number of marriages are not successful and it is comparatively easy to get a divorce, at the beginning of the 21st century divorce has become more widespread in Europe than ever before. At the same time divorce laws of the Member States are remarkably different, being quite liberal in some Member States and rather strict in others. Thereby, the material and procedural regulation of the institution of divorce varies significantly from one Member State to another.

In 2001 the Commission on European Family Law (CEFL) was established in order to facilitate the harmonisation of substantive family laws in Europe. In 2004 CEFL published the Principles of European Family Law Regarding Divorce and Maintenance between Former Spouses.[4] Although these principles are not law, but a legally non-binding model, they represent a significant step in the development of common divorce law in Europe. The aim of these principles is to represent the best of the divorce law provisions of the European countries; therefore they may serve as a source of inspiration for the national legislatures of those European countries which consider reforming their national divorce laws.[5]

Although 15 years have already passed since these principles were published, at present the huge differences in the national divorce law provisions of the

[1]Rheinstein (1953).
[2]Ibid at 4.
[3]Antokolskaia (2006) at 313-314.
[4]See Commission on European Family Law. EFL Series.
[5]Antokolskaia (2016) at 65.

Member States remain and it seems very unlikely that with the help of CEFL or in any other way it would be possible to unify or even harmonise the substantive divorce law provisions of the Member States. This is because the substantive family law of every country has always been and still is a very sensitive area which, a lot more than any other legal area, reflects the social, cultural and religious views of the particular society and where changes happen very slowly. It would not be an exaggeration to say that family law is one of the core law areas of any country.

Because of the foreign element, cross-border divorces are more complicated than regular divorces, since in the case of a cross-border divorce it is necessary to first apply private international law provisions in order to determine the competent court (jurisdiction) and the applicable law. However, national private international law provisions of the Member States contain various connecting factors (nationality, domicile, habitual residence) in this respect, which means that, for instance, according to the conflict-of-laws rules of one Member State the strict Italian divorce law might be applicable to a particular cross-border divorce, while according to the conflict-of-laws rules of another Member State the liberal Swedish divorce law might be applicable to the very same cross-border divorce. This shows that the legal consequences of a cross-border divorce can be very different depending on the competent court and the applicable law. Since the national private international law provisions of the Member States regarding cross-border divorce differ significantly, it leads to uncertainty as to the court of which Member State will eventually be competent to hear the particular cross-border divorce case and the law of which country will eventually be applicable to the particular cross-border divorce.

In order to overcome the differences of the substantive family law provisions on divorce between various countries, there have been attempts to unify private international law provisions on cross-border divorce, which began at the beginning of the 20th century and still continue today. The most prominent unification endeavours have been adopted under the auspices of the Hague Conference on Private International Law (HCCH).[6] Besides, some EU Member States have concluded bilateral agreements containing private international law provisions with several third countries, thereby unifying the provisions of private international law applicable in cross-border divorce cases in which these countries are involved.[7]

One of the fundamental freedoms of the EU internal market is the free movement of persons. This has resulted in a huge increase in the number of cross-border marriages, in which spouses have different nationalities or have different domiciles or have their habitual residences in different Member States. The huge number of cross-border marriages has in turn led to an increase in the number of cross-border divorces. At present the number of cross-border divorces in the EU is soaring.

[6]See HCCH. Conventions, Protocols and Principles.

[7]For instance, Latvia has concluded such bilateral agreements on legal assistance with Russia, Belarus, Ukraine, Kyrgyzstan, Uzbekistan and Moldova. Ministry of Foreign Affairs of the Republic of Latvia. Bilateral Agreements.

The EU realised that the uncertainty about the competent court, the applicable law and the recognition of judgment in a cross-border divorce case could possibly hinder the free movement of persons within the EU, which is vital for the functioning of the EU internal market. Therefore, even though the EU is a politically economic union, it adopted two regulations which contain unified European private international law provisions on cross-border divorce and the aim of which is to facilitate the complicated divorce process for those EU nationals and/or habitual residents who have concluded a cross-border marriage. Since uncertainty about a person's marital status could hinder the free movement of persons, the main aim of both regulations is to exclude such uncertainties. It should be noted though that according to legal doctrine this connection between family law and the proper functioning of the EU internal market is exaggerated.[8]

Council Regulation (EC) No 2201/2003 of 27 November 2003 concerning jurisdiction and the recognition and enforcement of judgments in matrimonial matters and the matters of parental responsibility (the 'Brussels II *bis* Regulation' or 'Brussels II *bis*')[9] determines jurisdiction and the recognition of judgments in cross-border divorce, legal separation and marriage annulment cases, while Council Regulation (EU) No 1259/2010 of 20 December 2010 implementing enhanced cooperation in the area of the law applicable to divorce and legal separation (the 'Rome III Regulation' or 'Rome III')[10] determines the law applicable to a cross-border divorce and a cross-border legal separation. Both regulations are directly applicable in those Member States in which they are legally binding, thereby replacing the national private international law provisions on these matters. Both of these legal acts are the result of difficult compromises and their in-depth analysis and application in practice over the years has identified their various flaws and problematic issues. Despite this, on 29 January 2019 the recently adopted Council Regulation (EU) 2016/1103 of 24 June 2016 implementing enhanced cooperation in the area of jurisdiction, applicable law and the recognition and enforcement of decisions in matters of matrimonial property regimes became applicable.[11]

Although the majority of legal experts believe that the EU does not have legislative competence in substantive family law, this point of view is debatable and some legal scholars have expressed their opinion that Brussels II *bis* is just a temporary solution, stressing that the best long-term solution to the conflicts sought to be resolved by Brussels II *bis* would be the harmonisation of the substantive divorce laws of the Member States.[12] As already mentioned, it is highly doubtful that this might ever be achieved, considering the huge differences between the sensitive divorce law provisions of the Member States. Yet, one might find interesting the suggestion to create a separate *matrimonium europaeum* or EU matrimonial law which would only be applicable in cross-border cases.[13]

[8]McEleavy (2002) at 897.
[9]Council Regulation (EC) No 2201/2003 of 27 November 2003.
[10]Council Regulation (EU) No 1259/2010 of 20 December 2010.
[11]Council Regulation (EU) 2016/1103 of 24 June 2016.
[12]Ní Shúilleabháin (2010a) at 22.
[13]Ibid at 23.

However, this suggestion too is debatable and requires a separate and detailed analysis. For now, as long as the differences in the substantive divorce law provisions of the Member States remain, European private international law provisions on cross-border divorce, namely, Brussels II *bis* and Rome III remain topical.

The aim of this paper is not to analyse in detail the problematic issues of Brussels II *bis* and Rome III since these have already been discussed in many articles, but rather to explore, analyse and discuss what effect some of the provisions of Brussels II *bis* and Rome III may have on the national family laws and international obligations of the Member States.

This paper consists of four sections following this introduction. First, there will be a review of Brussels II *bis* and Rome III, the relevant case law and the relevant and most up-to-date legal literature on the subject. It will be followed by a brief description of the methodology used in this paper. Afterwards, a joint section of findings/results and discussion will follow containing a critique of some of the provisions of both regulations in the way they may affect the substantive family laws of the Member States and their international obligations and suggesting solutions to some of the discovered problems. Finally, the conclusions of the research, findings/results and discussion carried out in this contribution will be listed in the form of theses.

Legal Acts, Case Law and Literature Review

Brussels II bis

In May 2000, the European Council adopted a regulation unifying the private international law rules of the Member States regarding jurisdiction and the recognition of judgments in matrimonial matters (divorce, legal separation and annulment) and matters of parental responsibility (the 'Brussels II Regulation' or 'Brussels II').[14] This was the first EU instrument to deal exclusively and directly with core family law matters, although it did so from a private international law perspective.[15] While at first it did not give such an impression, the adoption of Brussels II has since proved to be a watershed in the evolution of EU law with Member States having ceded their competence in very important areas of social policy.[16] Since Brussels II was criticised because of its unfair treatment of children born out of wedlock, it was soon replaced by Brussels II *bis*.[17] Thus, by adopting Brussels II *bis* the private international law provisions of the Member States (except Denmark)[18] regarding jurisdiction of cross-border divorce cases and the recognition of judgments in cross-border divorce cases have been unified. Yet, Brussels II *bis* has been heavily criticised by legal scholars for having various

[14]Council Regulation (EC) No 1347/2000
[15]Ní Shúilleabháin (2010b) at 1023.
[16]Ibid at 1022.
[17]Ní Shúilleabháin (2010a) at 7.
[18]Recital 31 of the Preamble of Brussels II *bis*.

errors and for damaging the general development of international cooperation in private international law on cross-border divorce, particularly undermining the standing of the HCCH.[19]

As already mentioned, some legal scholars see Brussels II *bis* as only a step towards the harmonisation of the substantive family law provisions of the Member States which according to their view is the only means of truly abolishing barriers to the free movement of persons.[20] While on the one hand it is possible to agree to this opinion, on the other hand one should remember that substantive family law is a very sensitive area of law in which changes over the centuries have occurred extremely slowly and which is very closely connected to the social, cultural and religious views dominant in the particular country. In legal doctrine it has been indicated that the fundamentally different family laws in different Member States have resulted from the differing value-systems in each country.[21]

Since each Member State has its specific policy on various issues and a unique culture, it would not seem right to unify or even harmonise the substantive family law provisions of the Member States. Especially because in some Member States religion still has a very important role in society and the canon law of the Roman Catholic Church is still seen as the ultimate guidance in family relationships (Malta, Italy, Ireland, Spain, Portugal, Poland, Lithuania), while in other Member States the majority of the population does not believe in the existence of God at all (Estonia, Finland, Sweden).[22] These huge differences are proved by the fact that Brussels II *bis*, which contains only European private international law rules, is already clearly problematic insofar as it puts Member States in the difficult position of having to choose between their EU obligations and commitment to their own policy in the family law area.[23]

Article 3 (1) of Brussels II *bis* provides for seven alternative[24] grounds of jurisdiction in cross-border divorce cases, in which the common habitual residence of the spouses, the last common habitual residence of the spouses, the habitual residence of one of the spouses, as well as the common nationality of the spouses (in the case of the United Kingdom and Ireland – the common domicile of the spouses) are used as connecting factors. Thus, Brussels II *bis* establishes a flexible choice of jurisdiction, which in turn shows that Article 3 is based on a liberal divorce philosophy (*favor divortii)*.[25] This relatively wide choice of jurisdiction has been and still is criticised by those legal scholars who believe it encourages forum shopping.[26] It should also be added that this unification of jurisdiction rules

[19]Ní Shúilleabháin (2010b) at 1043 and 1046.
[20]Ibid at 1027.
[21]Ibid at 1049.
[22]For instance, according to the Eurobarometer survey conducted in 2010, 94 % of the population of Malta said that they believe there is God, while only 18 % of the population of both Estonia and Sweden said that they believe there is God. Obviously, that is a huge difference in religious beliefs between EU Member States. Eurobarometer 73.1. Biotechnology (2010).
[23]Ní Shúilleabháin (2010b) at 1029.
[24]Case C-168/08 *Hadadi v Hadadi* [2009] EUECJ (16 July 2009) [48].
[25]Ní Shúilleabháin (2010a) at 149.
[26]Ní Shúilleabháin (2010b) at 1031-1036.

allows a cross-border divorce judgment pronounced in one Member State to be almost automatically recognised in the other Member States.[27]

At first Article 3 (1) of Brussels II *bis* in interaction with its Article 6 caused several questions, namely, is Brussels II *bis* applicable only regarding EU nationals and/or habitual residents and is it applicable if only one of the spouses is an EU national or habitual resident?[28] The answers to both of these questions were provided by the European Court of Justice (ECJ) in its judgment in *Lopez v Lopez Lizazo*, in which it was recognised that Brussels II *bis* is also applicable when only one of the spouses has a connection with a Member State stressing that, if in cross-border divorce proceedings a respondent does not have a habitual residence in a Member State un he/she is not a national of a Member State, the court of a Member State may not substantiate its jurisdiction to hear the petition with its national law, if under Article 3 of Brussels II *bis* the court of another Member State has jurisdiction.[29] From this judgment it follows that Brussels II *bis* is also applicable to nationals of third countries who have a sufficiently close connection with a Member State. Thus, the grounds of jurisdiction stipulated in Brussels II *bis* are applicable *erga omnes*.[30] Namely, Brussels II *bis* is applicable to not only couples in which both spouses are EU nationals or have their habitual residence in the EU, but also if only the respondent has EU nationality and/or a habitual residence in the EU, as well as if the respondent is neither an EU national nor has a habitual residence in the EU, but according to Brussels II *bis* a court of a Member State has jurisdiction to hear the particular cross-border divorce case.[31]

Pursuant to Article 7 (1) of Brussels II *bis*, if no Member State court has jurisdiction according to the rules of Articles 3, 4 and 5 of Brussels II *bis*, jurisdiction in each Member State shall be determined by its national law. This happens when the spouses have different nationalities (or domiciles in the case of the United Kingdom and Ireland) and their habitual residence is outside the EU.[32] Namely, these are cross-border divorce cases, in which each spouse has the nationality (or domicile) of a different Member State, for instance, the husband has Italian nationality, while the wife has Latvian nationality and at the same time neither of them has his/her habitual residence in the EU, for instance, the husband's habitual residence is in Canada, while the wife's habitual residence is in Australia.

The problem though is that Article 7 (1) of Brussels II *bis* may lead to a situation, in which no country has jurisdiction in the particular cross-border divorce case. A real life example of such a situation is described in the Report that the Commission gave to the European Parliament, the Council and the European Economic and Social Committee on the application of Brussels II *bis*.[33] Since

[27]Lamont (2007).
[28]Kruger & Samyn (2016) at 38.
[29]Case C-68/07 *Lopez v Lopez Lizazo* [2007] EUECJ (29 November 2007) [28].
[30]Persano (2010) at 10.
[31]Kruger & Samyn (2016) at 139.
[32]Ní Shúilleabháin, (2010a) at 158.
[33]See this example in footnote No 36 on page 8 of the Report. Report from the Commission to the European Parliament, the Council and the European Economic and Social Committee on the Application of Council Regulation (EC) No 2201/2003.

Brussels II *bis* should establish the jurisdiction of a cross-border divorce case if it turns out that no court has jurisdiction in the particular case, it would seem necessary to include *forum necessitatis* in Article 7 of Brussels II *bis* in the following wording: '*If no Member State court has jurisdiction in the particular divorce case and it is not possible to obtain the divorce in a third country, then, if the Member State, in whose court the divorce application has been lodged, has a sufficiently close connection to the case, the court of this Member State has the right to declare itself the competent court.*' A very similar suggestion has already been expressed by legal scholars, stressing that another reason why *forum necessitatis* should also be included in Brussels II *bis* are cross-border same-sex divorce cases.[34]

On 15 April 2014 the Commission gave a Report to the European Parliament, the Council and the European Economic and Social Committee on the application of Brussels II *bis*.[35] In the Report the Commission named several flaws of Brussels II *bis*, which have been identified since the start of its application in the Member States.

Firstly, the Report implies that if both cross-border spouses have dual nationality of the same two Member States, then, according to the judgment of the ECJ in *Hadadi v Mesko*[36], when determining the competent court in a cross-border divorce case, it is not necessary to consider which nationality is *effective*, but instead the courts of both Member States have jurisdiction. Thus, in this situation cross-border spouses have the right to choose the competent court.[37] Since this issue has already been resolved in the mentioned judgment of the ECJ, it should probably not be considered a flaw of Brussels II *bis* anymore, because from the wording of Article 19 (1) of the Treaty on European Union it follows that judgments of the ECJ are binding upon all the national courts of the Member States.[38]

Secondly, the Report states that another flaw of Brussels II *bis* is that the jurisdiction grounds listed in its Article 3 (1) are alternative, not hierarchical, which in conjunction with the fact that the conflict-of-laws rules on the law applicable to a cross-border divorce have not been harmonised throughout the EU, may lead to forum shopping. Namely, one of the spouses might rush to a court which is more convenient to this spouse, before the other spouse has managed to do the same, so that the law applicable to the particular cross-border divorce would be the law which better suits the interests of this spouse. This is because according to national conflict-of-laws rules the law applicable to a cross-border divorce

[34]See Kruger & Samyn (2016) at 140.

[35]Report from the Commission to the European Parliament, the Council and the European Economic and Social Committee on the Application of Council Regulation (EC) No 2201/2003.

[36]Case C-168/08 *Hadadi v Hadadi* [2009] EUECJ (16 July 2009) [48].

[37]Report from the Commission to the European Parliament, the Council and the European Economic and Social Committee on the Application of Council Regulation (EC) No 2201/2003 Concerning Jurisdiction and the Recognition and Enforcement of Judgements in Matrimonial Matters and the Matters of Parental Responsibility, Repealing Regulation (EC) No 1347/2000.

[38]Consolidated Version of the Treaty on European Union.

usually is the law of the court (*lex fori*) and only subsidiary – the personal law of the spouses (*lex causae*).[39]

One may find this conclusion of the Report to be only partly true, because typically the main reason for forum shopping is the desire for a particular law to be applied to the matrimonial property relations and maintenance.[40] Therefore, even if the conflict-of-laws rules regarding the law applicable to a cross-border divorce were unified in all the Member States, the problem of forum shopping would still remain. Furthermore, even if the conflict-of-laws rules on the law applicable to matrimonial property relations were unified in all the Member States (as already mentioned, there is the EU Regulation on enhanced cooperation regarding the law applicable to matrimonial property regimes[41]), the problem of forum shopping would still remain because of the procedural advantages that the court of one Member State might have over the court of another Member State.[42] There is currently no discussion in the EU as regards the unification or at least the harmonisation of national civil procedure laws of the Member States. To be fair, such a discussion seems very unlikely in the foreseeable future. Therefore, it seems that at present there is no solution to the problem of forum shopping.

Thirdly, the Report points out that yet another flaw of the jurisdiction grounds of Brussels II *bis* in cross-border divorce cases is that they do not provide for the cross-border spouses a possibility to make an agreement on the competent court. However, from Article 3 (1) subsection 'a' it follows that in the case of a joint divorce application cross-border spouses may choose between the courts of the countries, in which they have their habitual residences, since it stipulates that in the case of a joint divorce application jurisdiction lies with the court of the Member State, in which either of the cross-border spouses is habitually resident. This opinion has been expressed in legal doctrine on numerous occasions, including in the Commentary on Brussels II *bis*.[43] Therefore, it is possible to conclude that already now cross-border spouses have a limited possibility to agree on the competent court, choosing between the jurisdictions of two Member States in both of which joint divorce applications are allowed. However, it is hard to disagree with the suggestion expressed in the Report that the spouses should be given a wider option to jointly designate the jurisdiction of their cross-border divorce case.

Rome III

Soon after the application of Brussels II *bis* began, it became clear that the EU had set a goal for European private international law on cross-border divorce to contain not only the provisions on jurisdiction and the recognition of judgments in cross-border divorce cases, but also rules on the law applicable to a cross-border divorce. At first, the aim of the EU was to include such provisions in Brussels II *bis*. But in 2008 it was concluded that there are insurmountable

[39]Fawcett & Carruthers (2008) at 967.
[40]de Boer (2008) at 340.
[41]Council Regulation (EU) 2016/1103.
[42]Clarkson & Hill (2011) at 19.
[43]Borrás (2017) at 95. See, e.g. Shúilleabháin (2010a) at 137. See, e.g. Carruthers (2012).

difficulties which make it impossible to achieve this goal at that time or in the near future.[44] Therefore, it was decided to abandon the idea of European private international law that would determine the law applicable to a cross-border divorce.

However, Belgium, Bulgaria, Germany, Greece, Spain, France, Italy, Latvia, Luxembourg, Hungary, Malta, Austria, Portugal, Rumania and Slovenia submitted a request to the Commission, in which they expressed their desire to create an enhanced cooperation between themselves regarding the legal acts applicable in cross-border divorce and legal separation cases (Greece later withdraw its request).[45] Interestingly, nine of these countries were from the 15 so-called *old* Member States, which had joined the EU before 2004, while six countries were from the 12 so-called *new* Member States, which had joined the EU in 2004 or 2007. Namely, the enhanced cooperation was desired by more than half of the *old* Member States and by exactly half of the *new* Member States, which clearly demonstrates that the *old* Member States did not wish to go ahead without the *new* Member States.[46] As a result, the Council adopted Decision 2010/405/ES, allowing an enhanced cooperation regarding the legal acts, which are applicable to cross-border divorce and legal separation, thereby creating an enhanced cooperation in this area.[47]

This decision has been heavily criticised in legal doctrine.[48] One of the main reasons for this is that Rome III[49], which establishes rules on the law applicable to cross-border divorce and legal separation, is the first regulation on enhanced cooperation in EU history.[50] Thus, it has begun the so-called two-speed European private international law, which some legal scholars see as something negative.[51] This is arguable though, because a two-speed EU and the adoption of a regulation on enhanced cooperation is not necessarily a bad solution, if it is clear that at least in the near future it is impossible to reach unanimity among the Member States on the particular matter, since this solution allows the Member States to integrate in different tempo. This is actually a good thing considering that at present the EU has 28 Member States. It would not seem right to forbid integration between Member States wishing to integrate and being ready to do this. Besides, the fact that at least some of the Member States have been able to unify their private international law provisions on the law applicable to a cross-border divorce and legal separation promotes legal certainty and predictability on the particular matter at least among these Member States.

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[44]Recitals 4 and 5 of the Preamble of Rome III.
[45]Recital 6 of the Preamble of Rome III.
[46]Peers (2010) at 347.
[47]Recital 7 of the Preamble of Rome III.
[48]See, e.g. Fiorini (2010) at 1157. See, e.g. González Beilfuss (2013) at 32.
[49]Council Regulation (EU) No 1259/2010.
[50]Report from the Commission to the European Parliament, the Council and the European Economic and Social Committee on the Application of Council Regulation (EC) No 2201/ 2003.
[51]See, e.g. Peers (2010) at 357. See, e.g. Fiorini (2010) at 1157 and González Beilfuss (2013) at 32; Magnus & Mankowski (2017) at 12.

At present (August 2019) Rome III is directly applicable in 17 Member States – Belgium, Germany, Greece, Spain, France, Italy, Latvia, Lithuania, Estonia, Luxembourg, Hungary, Malta, Austria, Portugal, Bulgaria, Rumania and Slovenia.[52] The main reason, why the other 11 Member States are not participating in Rome III, is because they do not wish to apply foreign law. Firstly, because they oppose the difficulties and expenses created by the application of foreign law in general and, secondly, because they have objections against the possible content of the applicable foreign law, either because they do not wish to hinder divorce or – on the contrary – because they wish to support the institution of marriage and do not accept a legal regulation that is more liberal than their own law.[53]

The core or the main element of Rome III is considered to be the fact that its Article 5 (1) innovatively introduces a limited party autonomy as a connecting factor in cross-border divorce and legal separation cases.[54] Legal scholars of private international law positively evaluate the inclusion of party autonomy in Rome III, because it gives spouses a limited possibility to choose the law applicable to their cross-border divorce and legal separation with the aim of increasing flexibility and legal certainty.[55] It is important to note that among the Member States participating in Rome III, only some had recognised party autonomy in cross-border divorce proceedings before the adoption of Rome III.[56]

Article 8 of Rome III stipulates the law applicable to a cross-border divorce or legal separation, if the cross-border spouses have not made a choice according to Article 5 of Rome III or if the agreement made between the spouses on the applicable law has no legal effect. Although the wording of Article 8 is very similar to the wording of Article 5, there is a very significant difference between the two provisions, namely, Article 5 allows spouses to choose one of the four alternative laws applicable to a cross-border divorce and legal separation, while in Article 8 the four applicable laws are placed in a hierarchical order. Thus, the successive connecting factors in Article 8 are arranged as steps creating the so-called *Kegelsche Leiter* ('Kegel's ladder') – each subsequent connecting factor is subsidiary and only becomes relevant if the preceding connecting factor is not pertinent.[57] In legal doctrine this is called the combination of subsidiary connecting factors.

However, Rome III is criticised because it allows spouses to make an agreement on the applicable law very early[58], namely, spouses may designate the law applicable to their cross-border divorce even before the celebration of the cross-border marriage itself. For instance, potential spouses may choose the

[52]Law Applicable to Divorce and Legal Separation. National Information Concerning Regulation No. 1259/2010. The latest Member State to join Rome III is Estonia, with Rome III applicable there as of 11 February 2018. Commission Decision (EU) 2016/1366 of 10 August 2016 confirming the participation of Estonia in enhanced cooperation in the area of the law applicable to divorce and legal separation [OJ L 216 of 11.8.2016].
[53]González Beilfuss (2011) at 338-339.
[54]Viarengo (2014) at 551.
[55]Recital 15 of the Preamble of Rome III.
[56]Basedow (2012) at 139.
[57]Lein (2015) at 891.
[58]Kruger (2014).

law applicable to their cross-border divorce in a prenuptial agreement. As a result, the law applicable to the particular divorce might be the law of a country with which neither of the cross-border spouses has had a connection for a very long time.

Besides, an early agreement on the law applicable to a future divorce can lead to two more problematic issues. First of all, by the time the particular agreement becomes effective the circumstances of the cross-border marriage may have changed. For example, the marriage may no longer have a foreign element, if, for instance, the spouses now have a common nationality and have their common habitual residence in the country of their common nationality. Rome III does not deal with this issue. On the one hand, one might say that since there is no conflict-of-laws situation anymore, Rome III is not applicable and therefore the spouses' agreement on the law applicable to their divorce should not be taken into consideration. On the other hand, one might as well say that the particular marriage was cross-border when the agreement was made and that a legally concluded agreement should be fulfilled.[59] This second opinion seems more likely, because *pacta sunt servanda*. Thus, even past circumstances may lead to a present conflict-of-laws.[60]

Secondly, the content of the applicable law as chosen by the spouses may have been significantly amended over the time. As a result, the basic principle of Rome III – a deliberate choice by the spouses – might not be respected. Recital 18 of the Preamble of Rome III stipulates that each spouse must precisely know the legal and social consequences of the choice of the applicable law. There is some reasonable doubt whether this requirement would be met, if the spouses had made the agreement on the applicable law many years ago and over the years the content of the applicable law had been significantly altered.[61]

Methodology

The methodology used in this paper is a research, a critical evaluation, an analysis and a discussion of Brussels II *bis* and Rome III in order to discover the way this European private international law may affect the substantive family laws of the Member States and their international obligations. As a result of the methods used, conclusions are drawn and solutions to some of the discovered problematic issues are offered.

Findings/Results and Discussion

Having researched and made a critical evaluation of Brussels II *bis* and Rome III, as well as the relevant case law and most up-to-date legal literature, it is time to

[59]González Beilfuss (2013) at 42.
[60]Wiese (2015) at 860.
[61]González Beilfuss (2013) at 42-43.

turn to the analysis and discussion on how Brussels II *bis* and Rome III may affect the national family laws of the Member States and their international obligations.

First, it is necessary to analyse and discuss how the interaction between Brussels II *bis* and Rome III has resulted in Malta being forced to introduce divorce into its substantive family law. Until 2011 the institution of divorce did not exist in the Maltese substantive family law. Despite this, Malta had already joined Brussels II *bis* and Rome III before 2011.

The application of Rome III from 2012 could have led to the following situation: a Maltese couple who would not have been able to divorce in Malta, could have easily circumvent the Maltese national legal framework, if at least one of the spouses established his/her habitual residence in, for instance, Spain. In this case pursuant to Article 3 (1) subsection 'a' of Brussels II *bis* this couple could file for divorce in a Spanish court, which would then determine the applicable law according to Rome III, which is directly applicable in Spain. According to the positive public policy rule established in Article 10 of Rome III, if the law applicable pursuant to Articles 5 or 8 of Rome III does not provide for divorce, the court applies the *lex fori*. Thus, in this case the Spanish court would apply Spanish law and divorce the couple. Afterwards, according to Article 21 (1) and (2) of Brussels II *bis* this judgment could have been automatically recognised in Malta. Since it became clear that the application of European private international law would discriminate those Maltese couples who would not be able to find a possibility to file for divorce in another Member State, on 28 May 2011 a consultative referendum took place in Malta, in which the majority of voters supported the introduction of the institution of divorce into Maltese substantive family law. As a result, the Parliament of Malta was forced to amend the Civil Code and finally introduce the institution of divorce in Malta.[62]

This situation shows that modern European private international law has already had a profound effect on the Maltese conservative substantive family law that had been protected and cherished by the Maltese nation over the course of centuries because of the huge power that the Roman Catholic Church has had and still has in this Mediterranean Island. This is very important because it leads to a finding that the legal acts of the EU, which so far remains a politically economic union, could seriously affect the substantive family law provisions of its Member States in the future as well. The reason why European private international law may push the substantive family laws of the Member States in a certain direction, is because private international law and substantive private law are interconnected. This leads us to a discussion in what other ways could Brussels II *bis* and Rome III potentially affect the substantive family laws of the Member States and their international obligations.

For instance, at present (August 2019) exactly half of the 28 Member States have not yet allowed the celebration of same-sex marriages.[63] A number of these Member States also do not recognise same-sex marriages celebrated abroad. Meanwhile, according to the wording of Article 13 of Rome III the term

[62]Marinai (2012) at 266-267.

[63]Italy, Greece, Cyprus, Estonia, Latvia, Lithuania, Poland, Czech Republic, Slovakia, Slovenia, Hungary, Croatia, Bulgaria and Romania. European Union. Marriage.

'marriage' as used in Rome III is a concept that has to be interpreted autonomously, which therefore may also include unconventional types of marriage.[64] However, a precise interpretation of the term 'marriage' as used in Rome III may only be given by the ECJ. Since it is clear that the term 'marriage' should have identical meaning in all EU regulations on private international law, the interpretation of the term 'marriage' as used in Rome III should be consistent with the interpretation of the term 'marriage' as used in Brussels II *bis* which the ECJ has also not given yet.[65] It should be noted though that Annex I of Brussels II *bis* refers to 'husband' and 'wife' respectively, thus it could be concluded that from the language of Brussels II *bis* it follows that this legal act is only applicable to traditional marriages.[66]

However, there are several reasons, why it is more likely than not that the ECJ in its judgment will indicate that the term 'marriage' as used in Brussels II *bis* and Rome III includes same-sex marriages too. Already from the *travaux préparatoires* of Rome III it followed that cross-border same-sex marriages should also be included in the scope of this legal act. Namely, the Report on the Proposal for Rome III discussed the problems that could arise from the application of Rome III to cross-border same-sex marriages. Notably, out of respect for same-sex marriages the Report implied that it is necessary to include *forum necessitatis* in Brussels II *bis*.[67]

Furthermore, the acknowledgment that the term 'marriage' as used in Rome III includes same-sex marriages as well as polygamous marriages is especially confirmed by Article 13 of Rome III, which stipulates that a court of a Member State whose law does not deem the particular marriage valid for the purposes of divorce proceedings is not obliged to pronounce a divorce by virtue of the application of Rome III. It logically follows from Article 13 that a court of a Member State whose law does deem the particular marriage valid for the purposes of divorce proceedings is obliged to pronounce a divorce by virtue of the application of Rome III. It seems undoubtedly clear that Article 13 has been written with cross-border same-sex marriages and polygamous marriages in mind. The idea that the broader interpretation of the term 'marriage' as used in Rome III may also be substantiated with Article 13 of Rome III has also been expressed in legal doctrine.[68]

Besides, legal scholars have already expressed their opinion that the term 'marriage' as used in Rome III definitely includes both same-sex marriages and polygamous marriages, because, firstly, it would create difficulties in legal practice, if Rome III were not applicable to these two types of cross-border marriages, secondly, EU nationals, who have entered into such marriages, should not be deprived of the legal certainty, predictability and flexibility provided by

[64]Torga (2012) at 548-549.
[65]Ibid at 549.
[66]Ní Shúilleabháin (2010a) at 106.
[67]European Parliament. Report on the Proposal for a Council Regulation Implementing Enhanced Cooperation in the Area of the Law Applicable to Divorce and Legal Separation (COM (2010)0105 – C7-0315/2010 – 2010/0067(CNS)). (2010) at 31-33.
[68]Lein (2015) at 896.

Rome III, thirdly, these EU nationals should not be excluded from the goal of promoting the free movement of persons within the EU, and, fourthly, these EU nationals should not be discriminated on the grounds of their gender, religious affiliation or sexual orientation.[69] The prohibition of discrimination on the mentioned grounds is also expressed in Recital 30 of the Preamble of Rome III.

Thus, it is very possible that in the future, when giving an autonomous interpretation of the term 'marriage' as used in Brussels II *bis* and Rome III, the ECJ in its judgment may indicate that the term 'marriage' as used in Brussels II *bis* and Rome III includes same-sex marriages too. This will lead to all the Member States applying Brussels II *bis* and Rome III being forced to recognise cross-border same-sex marriages celebrated abroad and to carry out cross-border same-sex divorces. This in turn may lead to those Member States, which at present do not allow same-sex marriages, being indirectly forced to legalise same-sex marriages in their substantive family laws.

There is also a way in which the family law practitioners of the Member States may be affected by European private international law. This may happen when it is necessary to convert a legal separation into a divorce according to Rome III. Pursuant to Article 9 of Rome III when a legal separation is converted into a divorce and if the spouses have not agreed otherwise, the competent court who has been asked to convert a legal separation into a divorce pursuant to Article 9 (1) has the duty to decide the case according to the law applicable to legal separation even if the *lex fori* makes no provision for legal separation.[70] Thus, a Member State which participates in Rome III, but whose law has never provided for the religious institution of legal separation, for instance, Latvia, may be forced to deal with legal separation, if during the course of cross-border divorce proceedings a request is submitted to convert a cross-border legal separation into a cross-border divorce. This may prove to be rather difficult, if the legal practitioners of the particular Member State are unfamiliar with the institution of legal separation, which is often the case in, for instance, Latvia.

As already mentioned, pursuant to Article 9 (1), if a cross-border legal separation is converted into a divorce, the law applicable to this cross-border divorce is the law which was applied to the cross-border legal separation, unless the spouses have agreed otherwise according to Article 5 of Rome III. However, pursuant to Article 9 (2) if the law that was applied to the legal separation makes no provision for the conversion of a legal separation into a divorce, Article 8 of Rome III is applicable, unless the spouses have agreed otherwise pursuant to Article 5 of Rome III. Thus, the court, which has to convert a legal separation into a cross-border divorce, has the duty to check, if the law which was applied to the legal separation provides for the conversion of a legal separation into a divorce.

For instance, Italian law makes no provision for the conversion of a legal separation into a divorce because there legal separation and divorce are considered to be two separate legal institutions. Having not understood this, at present the German courts have created a wrong case law. Namely, before Rome III entered into force according to the German national conflict-of-laws rules Italian law was

[69]Wiese (2015) at 861.
[70]Lein (2015) at 912.

applied to the legal separation of an Italian couple with a habitual residence in Germany. After Rome III had become applicable pursuant to Article 9 (1) of Rome III the German courts apply Italian law to the cross-border divorces of these Italian spouses. This is wrong because since the Italian law does not make a provision for the conversion of a legal separation into a divorce, then, if the spouses have not agreed on the applicable law, pursuant to Article 9 (2) the law applicable to the cross-border divorces of these Italian spouses habitually resident in Germany is German law according to Article 8 subsection 'a' of Rome III.[71]

All the above mentioned suggests that the family law practitioners of all Member States participating in Rome III should be taught about the institution of legal separation, its legal consequences and the way it can be converted into a divorce. Therefore, perhaps special learning courses or seminars should be organised for the family law practitioners.

Another discussion-provoking issue arises out of the recognition rules of Brussels II *bis*. Article 22 of Brussels II *bis* establishes four grounds of non-recognition for foreign judgments relating to cross-border divorce and special attention should be paid to the fact that a judgment delivered in one Member State is not recognised in another Member State, if its recognition is manifestly contrary to the public policy of the Member State in which recognition is sought. Yet, the scope of the public policy clause of Brussels II *bis* is significantly limited with the help of its Articles 24, 25 and 26.

A Muslim divorce pronounced in a third country according to the *Sharia* will most likely be refused recognition in the Member States on the basis of the public policy rule. At the same time it should be noted that although that way by using the public policy rule of their national private international laws Member States may avoid the recognition of a Muslim divorce pronounced in a third country according to the Islamic law, there is a Member State which also allows a Muslim divorce pronounced according to the *Sharia* which could, according to Article 21 (1) and (2) of Brussels II *bis*, be entitled to an automatic recognition in the other Member States, namely, a *mufti* divorce in Greece.

As a consequence of a number of international treaties signed by Greece and Turkey, the *mufti*, who is the religious leader of the Muslims living in Greece, has been granted the power by law to decide according to the *Sharia* on the divorce cases of Greek Muslim couples living in Western Thrace. Thus, the *Sharia* has become a part of Greek law although it is only applicable to some 100,000 Greek nationals.[72] However, the decisions of the *mufti* do not have *res judicata* effect and are only enforceable after a decision of the Greek court.[73] In the so-called Borrás Report it has been indicated that Brussels II *bis* is only applicable to civil proceedings and all merely religious proceedings are excluded from its scope.[74] Yet, in the legal literature it has been stated that, if the *mufti* divorces were

[71] Viarengo (2014) at 558.
[72] Tsaoussi & Zervogianni (2008) at 209.
[73] Vassilakakis & Kourtis (2007) at 137.
[74] Borrás (1998) at 35.

excluded from the scope of Brussels II *bis*, it would not be fair to those EU nationals who are Greek Muslims living in Western Thrace.[75]

However, this opinion has been challenged, since in this case the civil court does not decide on the divorce itself, but rather only confirms a divorce that has already been declared. Thus, the main part of the divorce process takes place in a religious rather than in a civil context. At the same time the *mufti* divorces are not *purely* religious, because, after they have been confirmed by the Greek court, they become officially recognizable in Greece. Thus, if the main criterion in order to decide whether Brussels II *bis* is applicable is whether the divorce is recognised in the civil law of the particular country, Brussels II *bis* should be applicable to the *mufti* divorces that have been confirmed by the Greek court.[76]

Meanwhile, in the commentaries of Brussels II *bis* it has been stated that the *mufti* divorces are not included in the scope of Brussels II *bis*.[77] Although this is the opinion of Emeritus Professor Walter Pintens, a legally binding explanation on this issue may only be given by the ECJ. Thus, so far this issue remains unclear. However, it seems very likely that, if the Greek court has confirmed the *mufti* divorce and it is enforceable in Greece, Brussels II *bis* should be applicable to the recognition of the *mufti* divorce. Thus, if the divorce decision of the *mufti* has been confirmed by the Greek court, this Muslim divorce could be entitled to an automatic recognition in all the other Member States (except Denmark) pursuant to Article 21 (1) and (2) of Brussels II *bis*, despite the fact that the *Sharia* had been applied to this divorce.

Finally, another problematic issue may arise, if pursuant to Article 21 (1) and (2) of Brussels II *bis* Greece automatically recognises a cross-border divorce of a Greek Muslim couple from Western Thrace with a habitual residence in, for instance, France, to which French law has been applied instead of the *Sharia*. It is to be expected that, if a Greek Muslim couple from Western Thrace with a habitual residence in France files for divorce in France, pursuant to the positive public policy rule established in Article 10 of Rome III the French court would apply the *lex fori* (the French law) instead of the *Sharia* to this cross-border divorce. Afterwards, Greece would be obliged to recognise this cross-border divorce pursuant to Article 21 (1) and (2) of Brussels II *bis*. Would Greece thereby not breach its international obligations resulting from its international treaties with Turkey, which oblige Greece to ensure that all issues pertaining to the personal status of Greek Muslims would be resolved in accordance with their religious customs? It seems more likely than not that Greece would in fact thereby breach its international obligations.

As a result, according to present European private international law an awkward situation may be created in which a Member State may be forced to breach its international obligations in order to fulfil its obligations under European private international law. Therefore, perhaps a subsection 'e' should be added to Article 22 of Brussels II *bis* in the following wording: '*a judgment relating to a divorce, legal separation or marriage annulment shall also not be recognised, if it*

[75] Vassilakakis & Kourtis (2007) at 138.
[76] Ní Shúilleabháin (2010a) at 125.
[77] Pintens (2017) at 58.

does not correspond to the international obligations of the Member State'. This suggestion could help to avoid the described awkward situation.

Conclusions

1. It is possible to conclude that with the adoption of Brussels II *bis* and Rome III the EU has created European private international law on cross-border divorce, which has replaced the relevant national private international law provisions of those Member States which participate in Brussels II *bis* and Rome III.

2. While a critical evaluation of Brussels II *bis* and Rome III shows that these two legal acts have various flaws, discussion-provoking is the way Brussels II *bis* and Rome III may affect the substantive family laws and international obligations of the Member States. Modern European private international law has already had a profound effect on the Maltese conservative substantive family law. This is very important because it leads to a finding that the legal acts of the EU, which so far remains a politically economic union, could have a serious effect on the substantive family law provisions of its Member States in the future as well.

3. It is very possible that in the future, when giving an autonomous interpretation of the term 'marriage' as used in Brussels II *bis* and Rome III, the ECJ in its judgment may indicate that the term 'marriage' as used in Brussels II *bis* and Rome III includes same-sex marriages too. This will lead to all the Member States applying Brussels II *bis* and Rome III being forced to recognise cross-border same-sex marriages celebrated abroad and to carry out cross-border same-sex divorces. This in turn may lead to those Member States, which at present do not allow same-sex marriages, being indirectly forced to legalise same-sex marriages in their substantive family laws.

4. There is also a way in which the family law practitioners of the Member States may be affected by European private international law. This may happen when it is necessary to convert a legal separation into a divorce according to Article 9 of Rome III. This may prove to be rather difficult, if the legal practitioners of the particular Member State are unfamiliar with the institution of legal separation or have heard about it but are not fully aware of the regulation on legal separation. This suggests that the family law practitioners of all Member States participating in Rome III should be taught about the institution of legal separation, its legal consequences and the way it can be converted into divorce. Therefore, perhaps special learning courses or seminars should be organised for the family law practitioners.

5. Although so far this issue remains unclear, it seems very likely that, if the Greek court has confirmed the *mufti* divorce and it is enforceable in Greece, Brussels II *bis* should be applicable to the recognition of the *mufti* divorce. Thus, if the divorce decision of the *mufti* has been confirmed by the Greek court, this Muslim divorce could be entitled to an automatic recognition in all the other Member States (except Denmark) pursuant to Article 21 (1) and (2) of Brussels II *bis*, despite the fact that the *Sharia* had been applied to this divorce.

6. Finally, a conclusion may be drawn that according to present European private international law an awkward situation may be created in which a Member State may be forced to breach its international obligations in order to fulfil its obligations under European private international law. Therefore, it is suggested in this paper that a subsection 'e' should be added to Article 22 of Brussels II *bis* in the following wording: '*a judgment relating to a divorce, legal separation or marriage annulment shall also not be recognised, if it does not correspond to the international obligations of the Member State*'.

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The Contribution of Forensic Science to Establishing the Truth in Criminal Proceedings

By Elena-Ana Iancu[*]

This article is intended to highlight, on the one hand, the role played by forensic science (forensics) among criminal sciences in Romania, and, on the other hand, to present the specifics of forensic science in order to delineate it from other related sciences. Through an interdisciplinary approach, taking into account the fact that forensic technique, forensic tactics and, last but not least, forensic methodology serve the finding of truth in a criminal case, as well as the prevention and/or combating of deeds provided by criminal law, we will emphasise its autonomous nature in relation to other sciences, although the aims of sciences in the field of criminal sciences are common. The delineation of forensic activities from activities specific to other disciplines is essential for the substantiation of criminal policies, for drafting amendments of criminal legislation, putting forward proposals for best interinstitutional/intrainstitutional practices, especially when investigation is carried out by joint teams, and sometimes for transnational crimes.

Keywords: *Forensic science; Expert; Specificity; Methods of Proof.*

Introduction

In order to highlight the role of forensic science among criminal sciences, we consider it necessary to refer to the way in which forensics is defined as a science, the type of institutions whose curricula include forensics, the university degree programmes whose curricula include the study of this discipline, the general regulations containing provisions that have an impact on investigation activities, as well as the special laws governing the activities of the forensic experts.

Given the tripartite structure of forensic science as a science in Romania, taking into account its specificity, in view of the connection of forensics with other criminal sciences, through the method of scientific documentation, we may delineate the concepts used in forensics so as to highlight the specific features of activities included in forensic technique, forensic tactics or forensic methodology, which are sometimes closely related to the terminology used in the evidentiary processes regulated in the Criminal Procedure Code of Romania.

We also took into consideration, in the context of this article on forensic science, the need to contribute to sustainable development in the field of law. Each specialist who carries out activities specific to crime investigation and is a participant in the criminal proceedings also promotes the goals proposed by the 2030 Agenda for Sustainable Development - document adopted in 2015 at the

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UN General Assembly in New York, comprising 17 goals, as well as the values of sustainable development at national and European levels, as reflected by the National Strategy for Romania's Sustainable Development 2030, drafted by the Department for Sustainable Development[1]. In this respect, we refer to Goal 4 - "Quality Education" and Goal 16 - "Peace, Justice and Effective Institutions". As a result, all participants involved in the criminal proceedings, regardless of their situational plan, having the rights and fulfilling the obligations associated with their legal standing, must reflect upon their own actions or inactions, taking into account the provisions of the laws in force and the current and future impact of their actions, including as part of the process of sustainable development of institutions, by promoting interpersonal (group, public, mass) relationships regardless of the form of communication chosen or required by law.

Thus, in the case of participants, both intrapersonal communication and the method of interpersonal communication chosen, in all their forms, contribute to the development of institutions, the creation of a functional judicial system and of increased social capital.

Remembering the axioms of communication and the methods of communication that may be used in order to establish the truth in a criminal case, we find that written documents, verbal messages and non-verbal decoding are essential in the criminal investigation process, having the potential to validate or invalidate the means of evidence, the carrying out of the hearing of persons in compliance with tactical rules (e.g. without suggestive questions or reactions of approval/ disapproval upon receiving answers which might also be influenced through non-verbal communication), the corroboration of the evidence, and the observance of the deadlines stipulated by the criminal law, including those regarding the performance of judicial forensic expertise.

Being aware of the developments of forensics as a science in relation to the legislative changes that have occurred over the last 10 years in Romania, we will emphasise, through the historical method, on the one hand, the scientific foundations of identification – from classical to modern ones – and, on the other hand, we will highlight the succession of regulations which have had an impact on evidentiary processes. As a result, we will refer to modern systems used in forensic investigation, taking into account the trace-formation process, the modern means of searching for and detecting traces, the limits of trace-preservation in the context of the regularity of the transformation process, the possibilities of exploiting traces within the limits of the existing technique.

The interdisciplinary and/or multidisciplinary approach is suitable for delineating forensics from other related sciences without which it would not be able to achieve its purpose, such as criminal law, criminal procedure law, and criminology.

[1]According to Romanian Government Decision no. 313/2017.

Principles that Emphasise the Specificity of Forensic Science

In the Romanian literature specialised in forensic science[2], there are numerous definitions given to forensic science which refer to the tactical methods and the technical means applied in the search for and detection of traces, the investigation of the crime scene in the case of committing acts provided for by criminal law, as well as in the prevention of crimes.

In Romania, the forensic science discipline is studied within faculties that have the law degree programme included in their educational offer and within the educational institutions of the Ministry of Internal Affairs, a different number of hours being allocated thereto, according to the specifics of the educational institution. The initial training and professional development of forensic workers is a constant concern of education providers, who initiate and develop undergraduate, master's or doctoral degree programmes having in their curriculum the forensic science discipline or disciplines that contribute, through the content of the discipline sheets, to the development of skills specific to crime investigation specialists, having sound knowledge of the causes that determine the evolution of criminal phenomena and of the factors contributing to their dynamics. Thus, there are universities which, in addition to the educational offer of law faculties, through other faculties that have related multidisciplinary programs, through the curricula of the second cycle of studies – Master's degree (e.g., a Master's degree program of Forensic Chemistry, a Master's degree program of Applied Forensic Studies), aiming at the sustainable development of human resources that carry out activities in related fields which contribute to establishing the truth in criminal proceedings, offer Master's degree students the opportunity to study the discipline of forensic science. Also, disciplines such as forensic technique, forensic tactics and/or crime investigation methodology, may be studied through postgraduate programs of continuous professional training and postgraduate professional improvement programs provided by educational institutions.

According to the *principle of legality*, the activities carried out by forensic experts involved in criminal investigations may only be ordered, performed and exploited in compliance with the provisions of the Criminal Procedure Code. However, the tactical methods applied and the technical-scientific means used during their deployment must also be based on the rules of forensic science set out in best practice guides, which are not detailed in the legislation but are applicable in the matter.

According to the *principle of the regularity of trace creation and preservation*, the forensic value of the changes occurring during the perpetration of the acts provided by criminal law depends on the manner in which the changes were formed initially, on their category, on a number of environmental factors, internal and external, contributing both to the formation of traces and to their preservation, as well as on the methods and procedures applied during the search for, discovery, highlighting, recording and collection of the traces.

[2]Mircea (2004) at 3 and Stancu (2007) at 12.

From the *principle of identity*, it results that an object is identical only to itself, at a given point in time. Identity is of a relative nature[3]. However, in the process of forensic identification, on the one hand, as a result of the fact that both the trace-forming object and the trace-receiving object may undergo changes, and on the other hand, given that the conservation of traces is dependent on the environmental factors that act upon them, identity is the result obtained by going through the identification process[4]. In the Romanian Criminal Procedure Code, in Title IV which is entitled "Evidence, Methods of Proof and Evidentiary Processes", the legislator reserved Chapter III to the "Identification of Persons and Objects". Thus, Articles 132-137 contain general provisions applicable to the identification of persons and objects, without showing the rules according to which this activity is carried out. In this respect, we highlight Article 132, bearing the generic title "Purpose and Scope of this Measure", which provides that such a measure may be ordered if the identification of persons or objects is necessary in order to achieve the purpose, which is to clarify the circumstances of the case. It is apparent from the chapter that the legislator refers only to the identification made by persons, who have to be heard with regard to the person or object they are supposed to identify, before the identification is made. Also Article 136 bearing the generic title "Other Identifications", complements the meaning of the chapter as a general statement, the application of Article 134 "Identification of Persons" being, however, limited - "Identification of voices, sounds or other sensory perception elements". In forensic literature, this measure is detailed as "presentation for recognition", including the tactical rules applicable to this activity.

While the *principle of finding out the truth* is specific to disciplines in the criminal sciences branch, forensic science, through the tactical methods and the technical means it uses, contributes to the investigation of the crime scene, to the conduct of evidentiary processes, to the synthesis, analysis and comparison of the acts actually committed, and helps to associate the constitutive elements of the offence committed so that the correct legal classification may be performed, and the most appropriate evidentiary processes needed in order to investigate the offence may be ordered, as part of the criminal investigation or criminal prosecution.

Specifics of Forensic Activities and Evidentiary Processes

Expert reports and fact finding are regulated in Chapter IV of the Criminal Procedure Code of Romania titled "Evidence, Methods of Proof and Evidentiary Processes", and chapter VII titled "*Expert Reports and Fact Finding*" whose title was amended in 2013[5].

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[3]Ionescu (2008) at 19-20.
[4]Mircea (2004) at 12.
[5]Through Article 102, point 115 of Law no. 255/2013 implementing Law no. 135/2010 on the Criminal Procedure Code and amending and supplementing some regulatory acts containing criminal procedural provisions, published in the Official Journal no. 515 of 14 August 2013.

Thus, Art.172-Art.183 contain provisions regarding the ordering of an expert report, the appointment of the expert, the rights and obligations of the expert, the cases of incompatibility, the replacement of the expert, as well as the procedure for conducting an expert report. There are also provisions regarding the parties that should have the expert report conducted and cases where it is possible to order a supplementary expert examination or a new expert examination. Since 2014, when the Criminal Procedure Code came into force, the expert's hearing is mandatory in cases where the expert report is not complete, where there are contradictions between the conclusions of the expert report and the content of the report, where the conclusions are contradictory or ambiguous. Although in the general part of the criminal procedure reference is made to the evidentiary process, the expert report or the fact-finding report may be carried out by using technical means that are specific to the type of expert examination or fact finding, by experts in the field of expertise, and by way of exception by a specialist working within judicial bodies or by an external one[6] in situations where there is a danger of "disappearance of evidence or of change of a factual situation, or where the urgent clarification of facts or circumstances of the case is necessary"[7]. The limits for obtaining these methods of proof may be stated and put in relation to the quality of the technology used, the training of the workers involved in the process of exploiting the trace being examined, the method used in their performance. Even when referring to modern methods and means of identification, knowing the scientific foundations of identification, understanding the identifying characteristics and the classical, relatively stable elements of the trace-forming or receiving objects are elements that are essential to drawing the conclusions, and all the more so to explaining the way in which they were reached, in the case of an expert's hearing.

In the matter of the evidentiary processes of *hearing of persons*, the general rules are laid down in the Criminal Procedure Code, Chapter II, Section 1, Articles 104-106. The following sections of the chapter contain provisions covering the hearing of the suspect or defendant (Article 107-110), of victims (aggrieved parties), as the case may be, of civil parties and of parties with civil liability (Art. 11-Art. 113). An important part is given to the hearing of witnesses (Art. 114-124) and to witness protection (Art. 125-Art. 130).

In order to avoid mental manipulation and to validate or invalidate statements without influencing one's intimate conviction, the observation, decoding and interpretation of non-verbal communication may constitute an advantage for members of the crime scene investigation teams, in cases where people are present near the perimeter of the crime scene, as well as in view of discovering negative-controversial circumstances at the crime scene.

The possibility of ordering the hearing of the forensic expert in the criminal trial may lead to situations in which the results of the process of identification as recorded by the conclusions of the expert report are explained and detailed during the trial. This aspect is reflected by Article 179 of the Criminal Procedure Code, which bears the generic title "Hearing of Experts", which in paragraph 1 states that

[6]Article 172 of the Criminal Procedure Code, paragraph 10.
[7]Article 172 of the Criminal Procedure Code, paragraph 9,

"during the criminal investigation or the trial, an expert may be heard by the criminal investigation body or by the court" if the judicial body believes that "such hearing is necessary to clarify the expert's findings or conclusions". The same Article, in paragraph 3, provides that an expert's hearing is conducted according to the provisions regarding the hearing of witnesses, Articles 114-130.

In the Criminal Code of Romania, the Special Part, in Title IV, bearing the generic title "Crimes of Obstruction of Justice"[8] Article 273, under the generic title "False Testimony", in paragraph 2, the aggravated form of the criminal offence at letter c, provides that the active subject of the offence may be "a person who prepares an expert report or an interpreter". As a result, the expert may be the subject of the criminal offence of false testimony if "in a criminal, civil or other proceeding in which witnesses are heard, gives false statements, or does not tell everything they know regarding the essential acts or circumstances in relation to which they are heard"[9]. If the witness is an active subject of the abovementioned offence in its simple form (the legal punishment is imprisonment for no less than 6 months and no more than 3 years or the payment of a fine), we notice that the expert will be held responsible for the aggravated form of the offence, as a circumstantial active subject, the punishment provided by the law being imprisonment for no less than 1 and no more than 5 years, without alternative fine.

Although, currently, forensic science workers have information technology at hand, and implicitly, a modern means - the computer, which is integrated in an international/national or local automated system that helps the specialist to gather traces/impressions, to process them, as well as in the process of recognition, verification, identification and storage thereof, the automated programs with work modules which are used in order to carry out the evidence-gathering procedure as part of forensic expertise are based on the classic methods of comparison by juxtaposition, overlapping (through transparency, differences in shades of colour, alternative lines, bicolour), linear continuity (horizontal or vertical).

The use of information technology, of modern means of forensic identification through the complex software they involve might leave the impression that experts/specialists should only have knowledge of the work module which is used in the performance of the expertise/technical-scientific finding report in a certain field, without requiring a thorough knowledge of the notions of forensics in general and of the technique used in classical forensics in particular.

Of course, this is not true. There are numerous forensic activities which are interdependent, this aspect being true both for fieldwork and for activities carried out in specially designed premises or laboratories, each of them having to observe specific tactical rules and methods and means which are recommended in order for the activity to achieve its goal or for the traces to be exploited in the best possible way in an identification process. But, regardless of the technical means used, the achievement of the purpose of an identification process depends on several factors, such as: human factors, equipment used in the identification process, factors related to the complexity of the program, as well as factors depending on the

[8]Articles 266-288.

[9]Article 273, paragraph 1, the simple form of the offence, according to its typical nature.

limitations of the technology used, or/and wear and tear factors. In this respect, we provide the following examples:

- The different forensic value of the impressions/traces used, which is obviously determined by the quality of the search, discovery, highlighting, recording (fixation), collection, and transportation/ preservation activities;
- The benefits provided by the technical-scientific means, both in terms of the takeover of the images as permitted by the system (scanner, analogue video camera, analogue videotape recorders, digital photo cameras, any digital information storage media, peripherals of certain systems that allow direct fingerprinting), as well as the worker's level of knowledge and training at each stage of the activity, so as to maximise the benefits of the system in a certain process of forensic identification, on the basis of a trace, impression or image;
- The state of operation of the peripheral equipment necessary for the proper operation of the means in question, as a system (generally, a scanner, a colour printer, a PC, a video printer), for example in the case of Lucia Forensic, the calibration of the scanner prior to taking the image is essential;
- The observance of the main steps in the program being used and the filling-in of the mandatory fields in order to enable the opening of the application and comparison in the identification process;
- Establishing and marking general and individual features, calibrating an image and determining the dimensions of the objects or the routes illustrated thereby, bringing two images to the same scale, position and orientation for comparison purposes, comparing two static images or a static image and a live one, printing, saving and managing all the results of processing may influence the achievement of the purpose of the identification process, namely the establishment of identity.

The Activity of Forensic Expertise in Romania

The general legal framework for the activity of expertise is provided by Ordinance no. 75 of 24 August 2000 on the organisation of forensic expertise. In Romania there are two national forensic science institutes, in two ministries: the National Institute of Forensics within the Ministry of Internal Affairs and the National Institute of Forensic Expertise within the Ministry of Justice. At territorial level there are forensic services in each County Police Inspectorate that has as subordinate structures Forensic Science Services, and therefore, forensic experts. Judicial forensic expertise may also be prepared by authorised experts working in accredited private laboratories who are listed in the Nominal Table of authorised forensic experts "established at national level, drawn up according to specialties and updated by the Ministry of Justice"[10]. Depending on the expertise specialties, various categories of traces or impressions may be

[10]Article 1, paragraph 3 of Ordinance 75/2000.

arranged and exploited. The same Ordinance, in Article 2[11] provides for the following forensic expertise specialties:

a. Graphical and technical expertise of documents;
b. Print-related expertise of foot and hand traces;
c. Expertise of traces left by beings and objects;
d. Ballistic expertise of arms and munitions;
e. Physical and chemical expertise of material evidence;
f. Forensic expertise in land traffic accidents;
g. Forensic expertise in aviation traffic accidents;
h. Forensic expertise in maritime and fluvial traffic accidents;
i. Forensic expertise in explosions and arson;
j. Voice and speaking expertise;
k. Images expertise;
l. Biological expertise;
m. Genetic expertise;
n. Digital data and application expertise;
o. Simulated behaviour detection expertise (polygraph);
p. Drugs and psychotropic substances expertise."

However, regardless of the specialty, the expertise may be carried out by official experts and/or authorised independent experts, according to the provisions of the Procedure Code[12].

As a rule, the criminal investigation body, through a prosecutorial order, or the court, through a resolution[13], appoints a single expert. If the court orders an evidence-gathering procedure, the prosecutor may request that an expert recommended by him/her should participate in the expertise. The same possibility is given to the parties[14] and the main procedural subjects[15] regardless of who ordered the procedure.

The evolution of the legislation, the expansion of information technology, the diversification of the means of recording of the crime scene, including through the evolution of the judicial forensic (investigative) photography performed by unmanned aerial vehicles[16]brought about novelties in judicial forensic expertise, by broadening the possibilities to illustrate through photos the demonstration contained in the expertise. In the same sense, criminal investigation bodies have new opportunities to document the case by recording the crime scene, recording the changes that resulted from illegal activities, as well as illustrating the results obtained or drawing up the photo composition. We provide, as an example, the platform used in the field of forensic science "Lucia Forensic" with work modules,

[11]Amended by Law 156/2011, published in the Official Journal no. 519 of July 22, 2011.
[12]Article 172, paragraph 4.
[13]Article 173, paragraph 1, in relation to paragraph 2 of the Criminal Procedure Code.
[14]The defendant, the civil party, the party with civil liability, as indicated by Article 32 of the Criminal Procedure Code.
[15]The suspect and the victim, as indicated by Article 33 of the Criminal Procedure Code.
[16]Iancu & Păcurariu (2018) at 33-39.

which is used in order to capture traces/ impressions, as well as for processing, comparing, storing and archiving them, offering various advantages and opportunities in the preparation of specific expertise: *fingerprint-related (dactyloscopic) expertise, expertise of traces left by evidence (traceological expertise), graphical expertise, ballistic expertise,* based on the means of recording (fixation) used during the course of judicial activities on the field. Also, the Lucia Forensic software may be used to determine the dimensions of the *corpus delicti* objects, the distances required in the stage of demonstration by comparison, the angles which are essential to identifying forgeries, wear details, or identification characteristics reflected in the negative in the trace discovered, in the process of their exploitation in the laboratory. With regard to the identification of persons by their external features, we highlight the *spoken portrait* and the *identikit*, which may be achieved either by using the specific software or by having a forensic artist draw the identikit/ sketch portrait (forensic art), which artist should be endowed with talent, artistic skills and solid knowledge of judicial psychology, anatomy and anthropology. This is why, in forensic science, too, non-verbal communication is important in establishing a relationship of trust between investigators, artist, and the interrogated person. On the one hand, a truthful witness who is available for providing information and has no interest in the criminal case, can contribute to successfully generating the portrait of the wanted person, and on the other hand, the feedback from law enforcement specialists will negatively or positively influence the forensic artist and will highlight the effectiveness of the technical method in the process of investigation of a crime.

Findings/Results

Through its specific features, forensic science makes an important contribution to the prevention, discovery and investigation of offences, on the basis of the discovery of changes made in the environment, correlating the data stored and the computer systems managed by Forensic Science Services of the County Police Inspectorates or of the regional or national Forensic Institutes. Through the knowledge, use and selection of the most appropriate interinstitutional and/or intra-institutional forms of communication (written, verbal, non-verbal), in accordance with the legislation in force, by making use of the information obtained by reference to the situational plan specific to relations in the judicial activity, forensic specialists and/and forensic experts are involved in the criminal proceedings, along with other criminal trial litigants.

If we refer to the investigation of the crime scene and we take into account the specific activities that forensic experts may carry out within the investigated perimeter (searching for the traces, recording the crime scene by making the specific measurements in order to determine the ratio of the traces, by recording the crime scene by means of the investigative photography, by analysing the behaviour of the photographed subjects resulting therefrom, in cases where, after the acts provided by the criminal law were notified, the investigators came into contact with the perpetrator or the participants in the criminal act (co-perpetrator, instigator, accomplice) during the investigation of the crime scene. Such a circumstance could be exploited by the participants, either in order to transmit various messages to one another through the media directly in the information society, or to decode the non-verbal communication of investigators/members of investigation teams, anticipating their reaction and/or positioning in relation to the clues and/or first statements obtained. As a result, the application of valid rules in any investigation of the crime scene and the readiness to observe and decode the communication of the people around may be essential in the process of developing the versions in question and in corroborating the clues discovered since the phase of static investigation of the crime scene. Compliance with rules such as: the conduct of the investigation at the crime scene as soon as possible, in a thorough, planned manner, by observing moral requirements, under a single leadership, highlights the peculiarities of the evidence-gathering procedure, with reference to the fact that the investigation team may include forensic experts, forensic laboratory specialists of the county police inspectorates, depending on the type of offence committed and taking into account their work-related duties.

Also, before the punishment in the case is individualised, the participants in the criminal trial interact with one another, at some point, including in the trial stage, when the hearing of the expert, of the interpreter may be ordered or the judicial investigation may be ordered, and thus the forensic specialists or experts may participate in the determination of the actual circumstances in which the act was committed. In this respect, some relevant aspects may be the following: determining the manner in which a crime has been committed; identifying the means used in the illegal activities; assessing the state of danger created for the protected value; determining the nature and seriousness of the result produced or of other consequences of the offence; identifying the reason for the perpetration of the offence, the purpose pursued by the perpetrator; establishing the perpetrator's conduct before, during and after committing the offence, as well as during the criminal proceedings.

Although, as a result of the amendments to the Criminal Procedure Code[17], the rule in the matter is expertise, not fact-finding, "when there is a danger related to the disappearance of evidence or to the change of a factual situation, or when the urgent clarification of facts or circumstances of the case is necessary", the conducting of a fact-finding may be ordered. This may mean that forensic specialists are present at the crime scene in order to draw up the fact-finding report, in addition to other activities specific to crime scene investigation, in the static and/or dynamic phase/s. In such cases, if the judicial bodies believe that "an expert opinion is necessary or when the conclusions of the fact-finding report are challenged", the development of an expert report may be ordered, according to the provisions of Article 172, par. 12 of the Criminal Procedure Code. We note that, on the one hand, the specialist present at the crime scene for the purpose of conducting the fact-finding can only be heard as a witness in court, not as a circumstantial subject. As a result, there will the simple form of the offence of false testimony, while the expert will be held responsible for the aggravated form

[17]Which were substantial in 2014.

of the offence. On the other hand, protection measures may be ordered in relation to the expert under the same conditions as those regarding the witness[18].

Throughout the evidentiary processes, especially during the hearing of persons, in the case of interviews required in order to draw the identikit, by asking for impressions directly, it is important for the forensic expert/artist to know that any act of communication falls within a situational logic, that the person being heard communicates differently depending on the position he/she has in relation to at least the following aspects: his/her legal standing (locus standi), the spiritual content of the communication, what is the intention of his/her statements, what is the real purpose of the simulation, etc.

While in the investigation of the crime evidence-gathering procedures will be ordered for which specific preparation measures are required, the tactical rules and the means necessary in order to carry out the activity as such are to be found in internal regulations and best practice guides. Some of these rules and means are: *the search, the re-enactment, the (voluntary or forced) seizure of objects, the taking of photos, and the (voluntary or forced) seizure of documentary evidence*. The knowledge of the photographic technique, the knowledge of the typology of the person being searched and the putting to use of elementary judicial psychology knowledge, the tactical rules applicable to the types of search (house, computer, body, vehicle search) are stated in the specialised doctrine relating to the field of forensic science and in internal regulations, whereas the substantive and formal issues regarding the acts through which those activities are ordered, the judicial procedure that must be followed in order for them to be carried out legally are stipulated in the Criminal Procedure Code.

Conclusions

The delineation of forensic activities from activities specific to other disciplines is essential for the development of criminal policies, the substantiation of changes in criminal legislation, for proposals of best interinstitutional/ intrainstitutional practices, especially when investigating acts/deeds provided for by criminal law in joint teams.

Knowledge of the legislation governing the evidentiary processes in which forensic specialists bring their contribution, and a dissociation of the procedure from the technique used, the tactics applied are necessary in order to delineate the object of forensic science from other related disciplines, such as:

- criminology, which studies the causes, factors and typologies specific to criminal phenomena, as well as the dynamics of acts provided for by the criminal law;
- forensic (judicial) psychology, which is related to forensic science in that it “interprets human behaviours with criminogenic finality” and elucidates issues which arise as concrete, specific situations due to human behaviour

[18]Article 175, paragraph 6, in relation to Article 125, cumulated 126 or 127, as the case may be.

and/or objective or subjective conditions that may influence both the method of trace-formation at the crime scene and the process of development of the statements of the main trial subjects, of the parties or of other participants in the criminal trial, as part of forensic psychology;
- transversal psychology[19] with its specific fundamental themes, when studying the reactions of "the free and healthy human individual"[20] in the relationship between the person being heard and the investigator, in an attempt to explain the attitude and manifestations of the individual in his/her relations with himself/herself and with others.

The highlighting of the role of interdisciplinary research in sustainable development is important in view of achieving increased social capital. Thus, regardless of the methods of communication and the logic of the situational plan, the development of relationships for sustainable development is based on planning and programming, coordination and control, motivation, and resilience consultation.

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[19]Schwartz (2008).

[20]Schwartz (2005).

recommended by the parties in order to participate in the performance of forensic expertise, as well as of Law no. 567/2004 on the status of auxiliary specialised personnel working in law courts and prosecutor's offices attached to them.

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