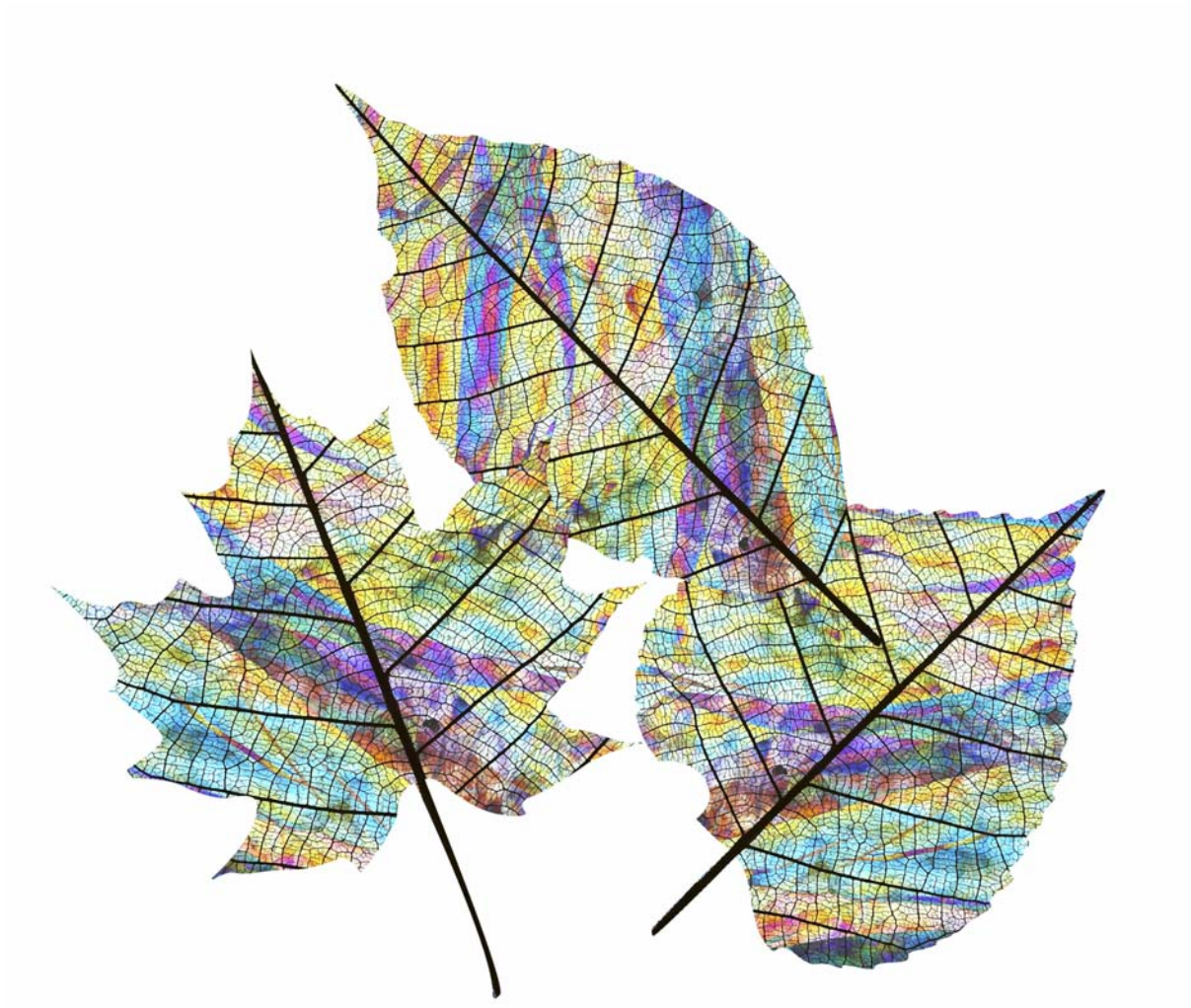
International legal risk for banks and corporates

A production of the Allen & Overy Global Law Intelligence Unit



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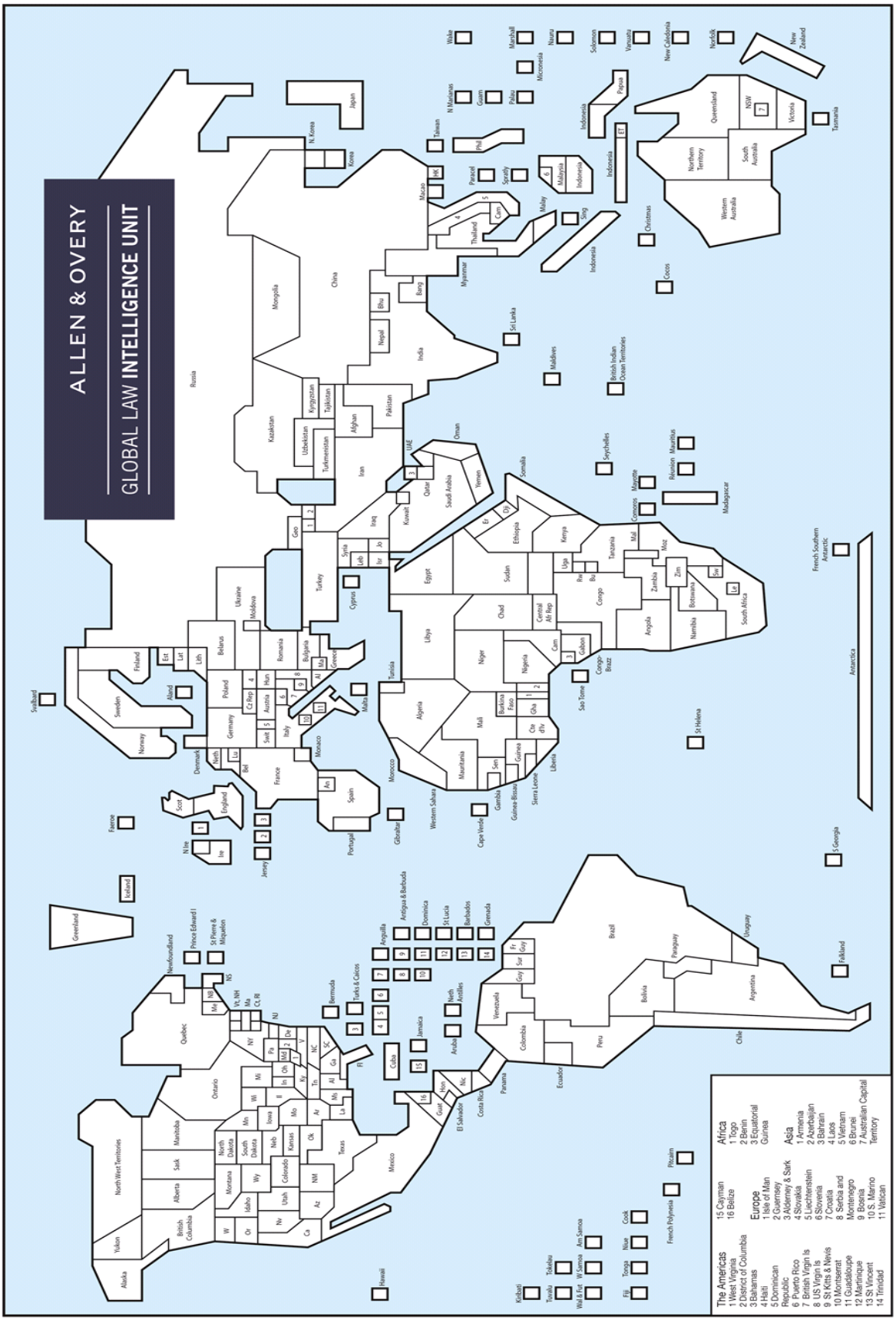

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International legal risk for banks and corporates

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by

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The law is our servant, not our master

Preface

This publication is intended to introduce a new approach to the subject of legal risk.

My conviction is that the international legal risks facing banks and corporates nowadays are major and in many cases disproportionate and that there are grounds for believing that the situation could get worse. This is considered detrimental to the peoples of the world and their future well-being.

There is a second volume containing charts of colour-coded indexes about legal infrastructure, the role of law and the like across most countries. The charts are based on rankings compiled by third parties, such as the World Bank and Transparency International. The charts were prepared by Melissa Hunt, project director at the Intelligence Unit.

Naturally, the opinions expressed in this Intelligence Unit paper are not necessarily the views of my firm or its members.

This edition is a limited circulation version to test views. There are a number of important areas which need to be developed in a subsequent edition.

I am grateful to those who commented on this text, including Heath Tarbert, James Partridge, David Wakeling and many others.

Philip R Wood QC (Hon)
Head of the Allen & Overy Global Law Intelligence Unit

April 2014

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Summary of main conclusions

The following are some of the main conclusions of this work:

- There has been a massive increase in legal risk for banks and corporations over recent years. This increase results mainly from (1) the intensification of regulatory regimes (of which there are nearly 30), (2) the fact that nearly all of the world's 320 jurisdictions are now part of the world economy, (3) the increase in volatility of the law, (4) the tiering or layering of domestic legal systems, (5) the disparity in many countries between the written law and how it is applied, and (6) extraterritorial legal regimes.

- The increase in legal risk is disproportionate and unnecessary. A situation where the law becomes an enemy, not an ally, is unjustifiable. It is unsatisfactory that banks and corporations have to assume the enormous burden of legal and similar expenses in order to mitigate legal risks or to fight oppressive litigation.

- Many people forecast a large increase in world GDP in coming decades, mainly in emerging countries, which should lead to a massive increase in the volume of transactions and in their value.

- The vast amounts of capital sloshing around will not go under the mattress but will go into banks and other corporations. This may well lead to greater prosperity but it also likely to lead to more crises and bankruptcies, more disputes and more litigation. This could result in more law and hence greater legal risks – a worsening of the legal environment from the point of view of banks and corporates.

- If this happens, the increase in GDP, the increase in transactions and the potential increase in crises would each drive an increase in the number of lawyers globally. They would in particular intensify the demand for international lawyers competent to advise on global risks. This could impact on the future size of law firms and in-house legal and compliance departments. The cost of legal services in this arena of wholesale international law would hinge, amongst other things, on the supply of lawyers able to carry out the above tasks.

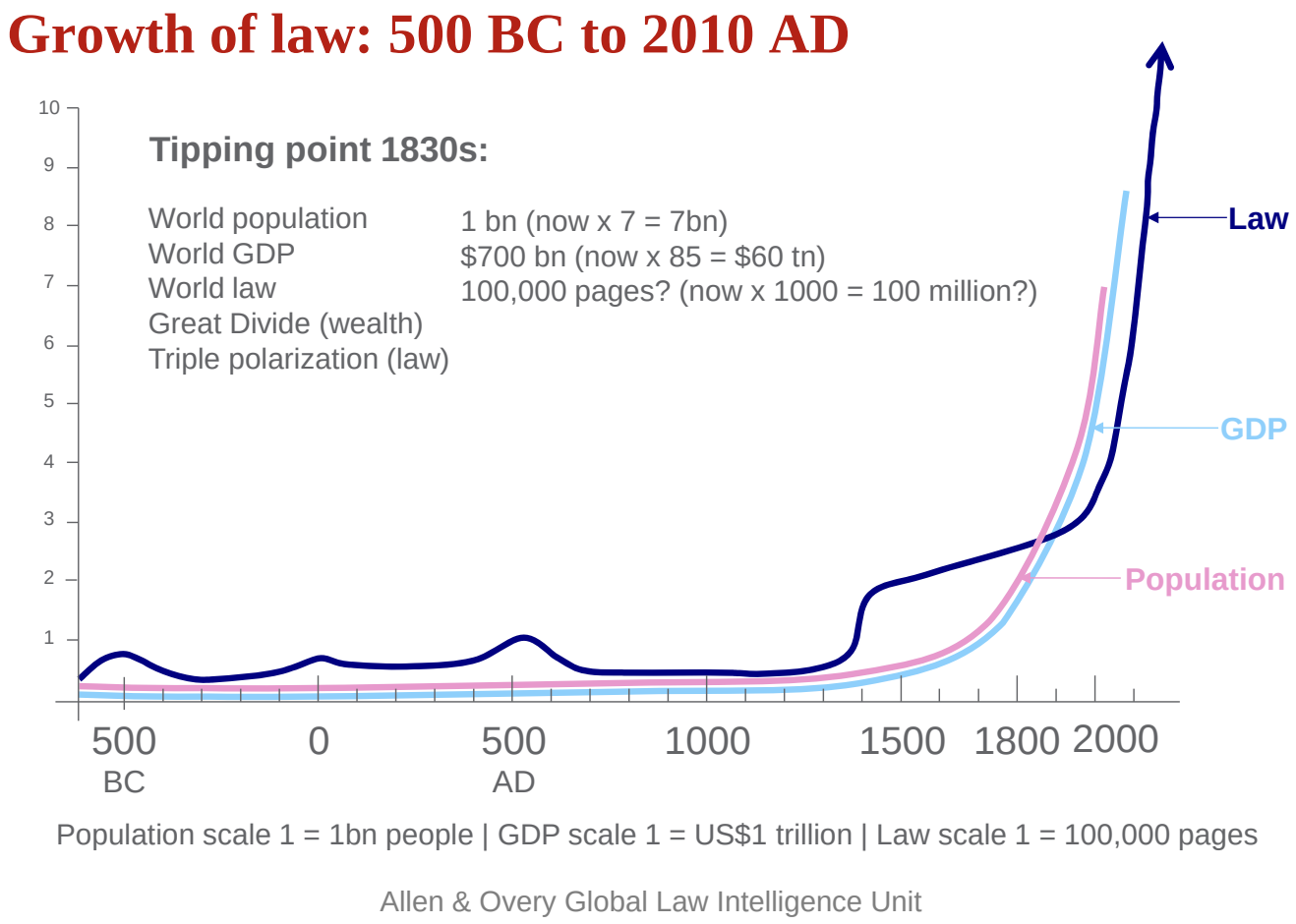
- The legal risks considered include (1) bankruptcy legal risks (2) regulatory legal risks, (3) extraterritorial legal risks (4) contract legal risks, (5) litigation risks and (6) rule of law risks. We identify some of the specific risks and outline methods of mitigation. In some cases it is not possible to mitigate the risks, except by closing down an otherwise useful line of business – an absurd result.

- Notwithstanding the obvious advantages of harmonisation of the law and the commoditisation of transactions in terms of cost, time and efficiency, both harmonisation of law and standardisation of major wholesale transactions seem to be even further away than before. This is so in spite of the ready

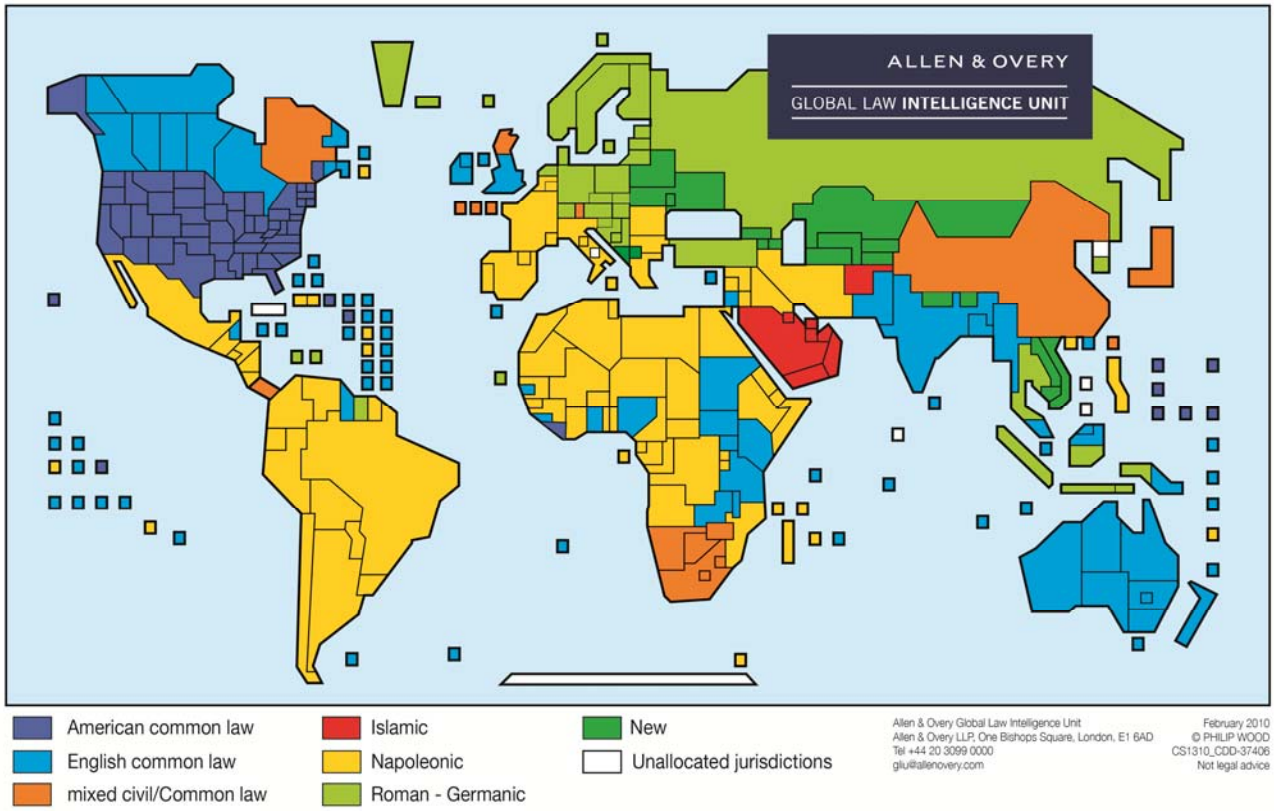
availability of technological solutions. This situation seems to be the result of the simultaneous impact of a legal revolution and an economic revolution, plus other factors.

- The rule of law applies just as much to the law applicable to money, banks and corporates as it does in other fields.

- The law is a universal religion which everybody believes in. It is the bedrock of our societies and survival. But the law will lose its appeal if it becomes a burden, if it becomes an instrument of oppression, if it manacles and fetters our legitimate freedoms. The policy-makers who deal with our laws should consider two rules: (1) keep it simple, and (2) do the arithmetic.



Families of law



Chapter 1

Introduction to legal risk

Law and risk

The law creates risk. This is because the violation of the law results in some sanction, either a criminal sanction or a civil sanction in the form of damages or some other remedy. But one of the basic objectives of the law is to reduce risk and thereby improve the chances of survival. This collision of objectives is at the heart of the study of legal risk. It is at the heart of the study of the law, whether we should be free or not free.

There are a number of reasons why the understanding and management of legal risk are crucial. The reasons include the following:

- Legal risk can give rise to unexpected and huge losses, sometimes so large that a bank or corporation collapses into bankruptcy, thereby causing substantial losses to shareholders and creditors, to the people who work in the bank or corporation who are then thrown out of a job, to counterparties who deal with the corporation who may then be pushed into domino or cascade bankruptcies, and sometimes losses to the whole of society.

- Legal risk can lead to criminal penalties for senior managers. It can lead to arrests at the airport and incarceration in some dismal prison for an economic or regulatory violation which is in perception technical, and a million miles away from the basic crimes of murder, assault and theft which everybody understands and which must exist for the protection of societies.

- It can lead to disqualifications and ostracism, inability to earn one's living, exclusion from listing and from public contracts, demotion to the status of outcasts.

- Legal risk can devastate the reputation of businesses and the individuals who work there, bring them into disgrace and cause them to be treated with scorn and contempt.

The general counsel of banks and corporations will have their own top ten lists of legal nightmares. These might include:

- A disaster, such as a factory explosion, an oil spill or a collapsed building injuring many people.

- A massive product liability, such as the mis-selling of a bulk financial product or the mass recall of cars with a dangerous fault or contaminated food or a drug which goes tragically wrong.

- A destructive cyber attack.
- A rogue trader whose unauthorised trades incur huge losses, an unauthorised deal which commits the corporation to a foolish venture, or a gigantic fraud.
- A bribe paid by an employee to a government official in some far-off country where a subsidiary is located.
- An incredibly stupid remark by an employee in an email.

These mishaps for a bank or corporation can have dramatic and savage consequences. The 24-hour internet means that bad news of legal nightmares can travel worldwide almost instantaneously. But meanwhile there are other legal risks, insidious legal risks, silent legal risks, creeping up out of the forest, which lead to a steady blood-letting of the profits and assets of a business, which clog up the arteries of the business, which cumulatively drag down the business, risks which arise from the sheer size and incomprehensibility of the law and its arbitrariness.

One can spend too much time defining legal risk. Either the definition is so broad and generic as to be meaningless, eg legal risk is something which causes a loss attributable to legal uncertainty, or attributable to a legally faulty transaction or non-compliance or compliance with a law, or something which has an adverse legal consequence. Even a hurricane, which is not a legal event, can have legal consequences, eg because employees get hurt. Or else the definition is a long list of specific examples which, however, misses out something really important, just because there are so many of them. We can let taxonomy rest – for the moment.

Why global legal risks have increased

Over recent decades legal risks have intensified around the world. The following are the main reasons:

- The volume of law is now out of control internationally and is unmanageable.
- A large part of this increase of risk results from the intensification of regulatory regimes, notably in the West. These regulatory regimes, of which there are a great many, typically criminalise the ordinary law and are sometimes aggressive. In some cases, particularly large parts of financial regulation, their usefulness is questionable.
- Almost all jurisdictions are now part of the world economy in the sense that they have businesses, banks and corporations which do business with other countries. Few countries are hermetically sealed off. Out of the just under 200 countries, there are about 320 jurisdictions and almost all of these now participate in world markets. See the map "**Families of law**" below. Even Sao Tomé,

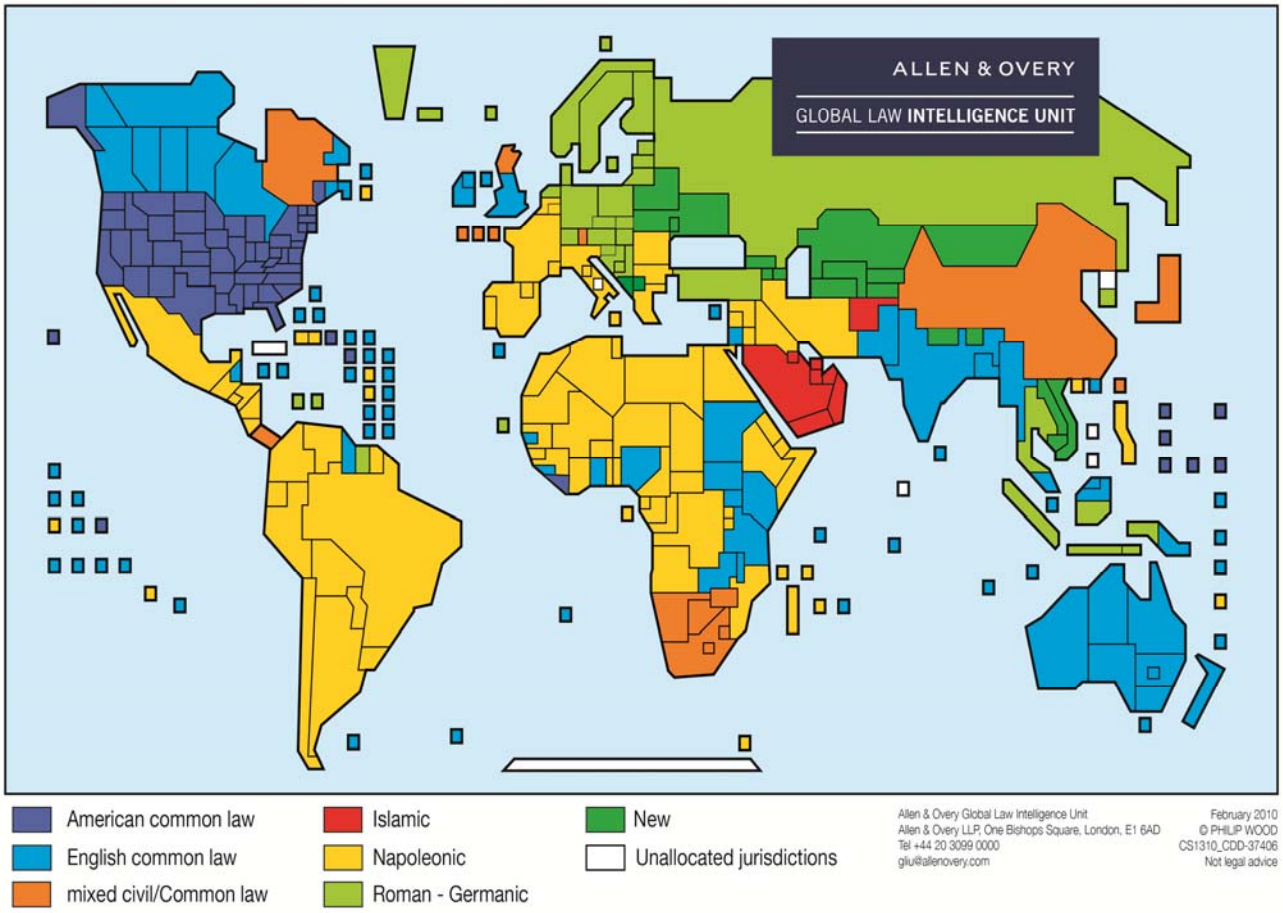
even Chad, even Kyrgyzstan, are interested in advancing their economies and are no longer cut off from the rest of the world. Only a few countries stand loftily apart, either resentfully, such as North Korea, or because they are not really interested, eg Bhutan. Even Cambodia has a stock exchange. This is globalisation in action.

- The law is much more volatile than it has ever been and changes rapidly, sometimes with no apparent reason, arbitrarily, just because somebody wants to fiddle with the law, or has a flash of anger.

- In developed countries, domestic financial and corporate law is breaking up into tiers or layers internally, with different protections for different sectors of the population, usually politically driven.

- There is great diversity around the world as to how the law is actually applied and the rule of law. For example the basic law in Congo-Kinshasa and Belgium derives from the same roots but the application is very different. One therefore has to cope with a double layer – the written law, or the law on the books, and then how it is applied.

Families of law



The issues of the quantity and volatility of the law, as well as the double layer of law on the books overlaid by how the law is applied, are dealt with in later chapters.

Predictions for the future

We suggest that legal risks for banks and corporations have increased by at least 1,000 times over the past four decades. There are grounds for believing that the risks could get worse, much worse. If it does, then the management of international legal risk for banks and corporates will become even more important than it is now.

A situation where the law becomes an enemy, not an ally, is unjustifiable. A situation where banks and corporates have to assume the enormous burden of legal and similar expenses in order to mitigate legal risks or to fight disproportionate litigation is deeply unsatisfactory. A situation where regulatory law, especially financial regulation, creates huge risks, and leads to massive extra legal and compliance costs, but where certain of the regulatory rules are nevertheless of dubious value, is contrary to common sense and the best interests of our societies. The law must be our servant, not an instrument of oppression.

We set out below our predictions for the large increase in world GDP, especially in emerging countries. If these predictions are correct, there will be an increase in the volume of transactions and in their value. This is likely to generate more disputes and more litigation. We believe that the vast amounts of capital sloshing around could create more crises and bankruptcies, leading to more controlling law, leading to more legal risks. All these factors would result in a worldwide increase in the number of lawyers and intensify the demand for international lawyers competent to cope with the risks. This would impact on the future size of law firms and the size of legal and compliance departments in international banks and corporates.

Lawyers are ultimately the guardians of the moral order and the law is fundamental to our societies.

The predictions as to the growth of transactions, of law and of legal risk are explained in chapter 4. The figures on the numbers of lawyers are dealt with in the last chapter 15.

Despite the technological revolution, we conclude that the simultaneous impact of the legal revolution plus the economic revolution means that international harmonisation of law and commoditisation of major transactions are even further away than before. This seems to be so, notwithstanding the obvious advantages of standardisation in terms of cost, time and efficiency. We do not think that law and lawyers will wither away. Quite the contrary, in fact. See chapter 5.

We also conclude that emerging countries should be cautious about intensifying the legal risks in their legal systems by slavishly following over-engineered Western models.

But before we get to those topics, there are some fundamental issues which must be dealt with first.

These fundamental issues are:

- "What is the law for and why does it create risk?" and
- "Why do banks and corporations attract legal risk?".

We also need to debate in detail some predictions about the future.

Chapter 2

What is the law for and why does it create risk?

What the law is for and why it creates legal risk will be answered by reference to a parable or allegory of two very famous paintings and a photograph, each displayed in these pages.

The first painting is the famous allegorical painting by Delacroix "**Liberty leading the people**", painted in 1830 and hanging in the Louvre in Paris. The whole of society is represented in this picture – the merchant class, the academics, the military, the peasants and youth. All of the people in this tumultuous scene are astir and infused with some burning ideal. They are well-armed. The youth has two pistols. The representative of the merchant class, with the big black hat, holds a formidable barrelled gun. Liberty herself clutches in her left hand a long rifle with the bayonet out. These people intend to get their way for their cause, whatever it is.

Liberty leading the people

In the original, the lady is holding the French tricolour flag. In our version she is holding the flags of many nations because the issue is not just limited to France in 1830. The boldness of her ideal is symbolised by the fact that she does not care one way or the other whether she does up her buttons. The revolution always happens when you are in the shower.

In Delacroix's mind, the liberties she was fighting for were basic political freedoms of democracy, freedom of speech and the like, freedom from despotism and autocracy.

You could also say that what she allegorises is freedom from restriction, a universal symbol of our hopes and aspirations.

Some of the biggest restrictions in our lives are the restrictions imposed by legal systems, customary law, statutory law, morality translated into mandatory codes. Indeed you could say that the law is entirely a system of restriction, manacling, fettering and tying us down. Two of the most restrictive areas of law are the financial regulatory and corporate regulatory codes. Of all fields of law, apart from tax, it is probably these which are the most intrusive and invasive.

Freedom and liberty are not concepts known to the law applicable to banks. Banks are ordered about from the cradle to the grave, the womb to the tomb. It is hard work even to be born as a bank. The authorisation barriers for a new birth are virtually insurmountable. Throughout your life as a bank, you are told how much money you must hold in reserve, how much ready money you must have, what you do day and night, who your partner is, all in the most incredibly intrusive manner so that there is always a camera watching you, even in your bedroom. Somebody listens in to your most private calls and checks through your emails. Your cleaner gets a huge bounty if she spies on you.

So far as banks are concerned, and also ordinary corporations, the blue sky is blotted out by the bars and chains of law. A cowering and frightened populace use the law to snap at each other. A frightened government uses the law to snap at its cowering populace. A frightened government and the cowering populace use the law to snap at foreigners.

The answer to the question of why all this is considered necessary, is debated in the next painting.

Raft of the Medusa

This is "**The Raft of Medusa**" painted by Géricault between 1818 and 1819. It also hangs in the Louvre in Paris, a stupendously huge canvas, in the same hall and on the same side and on the same wall as Delacroix's picture. This is one of the most iconic and powerful pictures ever painted. It really gets to the point – the point of where we are and what we are.

The French frigate the Medusa hit a sandbank off the west coast of Africa, then Senegal but now Mauritania, on 2 July 1816 at 3.00 pm. The terrified passengers and crew built a raft out of parts of the ship. The idea was that the crew would tow the raft with six rowing boats to the nearest coast. Hence nothing was left on the raft to navigate, no oars, no compass, no rudder.

The crew, including the captain, had other ideas. They cut the tow ropes and disappeared over the horizon. Most of them died on the 300 kilometre walk along the desert coast to St Louis in Senegal. The raft was left to float around helplessly in the scorching mid-summer Saharan sun.

Altogether 147 people got on the raft. There was one woman who was subsequently thrown overboard because she was screaming. When the 147 first got on, they were up to their waists in the sea. So they threw away some of the barrels of biscuits and brandy to lighten the load.

They rolled around in the sea for the next 12 days, before they were rescued by the brig Argus. Only 15 out of the 147 survived. In fact Géricault has 20 survivors in his picture for the sake of the composition. In

particular he painted in three Africans, including the man waving his shirt at the distant rescuing ship, in order to celebrate his views about the anti-slavery movement, freedom and liberty.

The man pointing excitedly is Corréard who subsequently wrote an electrifying and accusatory best-seller about what happened on the raft. This set him on a collision course with the authorities. The figure with black hair lying on his face with his hand over the beam is Delacroix, the same Delacroix who painted "Liberty leading the people". He was a friend of Géricault. When he first saw this painting, it was reported that he ran down the Place de Vendôme in Paris screaming from terror and ecstasy.

The picture portrays the immensity of human nobility of suffering and courage in the face of adversity. The figures are heroic, yet the reality was very different. When the rescuing ship arrived, the raft stank. The survivors were crazed. There were bits of human flesh hanging on the makeshift mast to cook in the sun.

Most of those who died on the raft did not die from famine or thirst. They were killed in the fighting for the remaining brandy and biscuits.

A schooner discovered the hull of the Medusa 52 days after the shipwreck. Three people were still on the ship. If everybody had not panicked and had stayed on board, they would probably all have survived. That is how you make simple mistakes when fear and unreason take over.

So the main question which this picture poses is whether Delacroix's lady with the flags continues to be right in her ideology when we are on the raft. Can we survive with liberty and freedom from law when we are in dire straits? If our banking systems or our corporations are shipwrecked, don't we need iron rules for that situation – to try to avert the disaster and then deal with it toughly when it happens? Does not liberty deserve to be snuffed out when survival is at stake?

Our third picture is of the **Chilean mine disaster** in 2010.

Chilean miners

(*Photo from the Observer, 17 July 2011*)

On 5 August 2010, 33 miners were deep down in the San José mine. They had stopped working for lunch in a tiny safety shelter which was 688 metres underground – more than half a kilometre or nearly half a mile. Ten minutes later there was a huge crack and rumbling, a thunderous sound reverberating through the mine.

A massive slab of rock the size of a skyscraper had shed off the mountain, trapping the men below tons of collapsed rocks.

They were down in the mine for 69 days. There were 33 of them. All of them survived.

Yet in the comparable case of the Medusa, only a fraction survived. So what was the difference, apart from the obvious difference of circumstances?

One of the key differences was that the miners, faced with their terrible predicament, made rules. They elected a leader, a captain of the ship. They measured their available food and water and agreed on the rations for each person for each day. They were not university-educated learned types, but they all had an instinct about what had to be done.

So they passed laws, they constituted a makeshift legal system to govern their conduct. There was a captain who was to be in charge and whom they would obey and who would not leave the ship (impossible in any event). They parcelled out the food on an equal basis since, in the face of death, we are all equal.

So that is the answer as to why we have law. We have law in order to survive. These laws create risks, to be sure, but the risks are created in order to surmount a much greater risk.

These survival laws are not just basic and primitive laws about torture, murder, robbery or war. The laws of survival include laws about money, about banks, about securities settlements systems, about bankruptcy, about corporations, about corporate governance, about maintenance of capital, about directors' duties, about food labelling, about data protection, about competition between businesses, all the mighty stacked-up array of our legal systems from top to bottom.

This still leaves the basic questions. What should our laws say? What law should give rise to civil liability for damages and which should be criminalised? How much law should there be?

We still have to resolve the issues of freedom against despotism, of anarchy against discipline. We are still left with the question of how much risk we create in order to control risk. And how much it costs.

There is another version of Delacroix's famous lady. This is the figure which faces you as you come into New York harbour. She is slightly better dressed than Delacroix's version. She is holding, not a gun, but rather a torch in her uplifted right hand. In her left hand she holds a tablet invoking the law. She represents not only liberty, but also welcome to the peoples of the world: she represents the idea of one planet. And she represents the rule of law.

Statue of Liberty

Chapter 3

Why do banks and corporations attract legal risk?

The question

There seems no doubt that the legal regime governing banks and ordinary corporations is considerably more intense and intrusive than the individual citizen would find acceptable. Their day-to-day conduct is regulated to a quite extraordinary degree.

Why should this be so? Part of the solution is to be found from an analysis of what banks and corporations actually do.

What do banks do?

The history of some of our greatest inventions is comparatively recent, only a few hundred years. Galileo remarkably proposed that our planet earth is going around the sun, not the other way round, a pronouncement which was met with astonishment by some and indignation by many. Galileo died in about the same year that Newton was born – 1642. A few decades later, Newton in 1687 published his revolutionary equation which showed that there was a very precise mathematical relationship between mass and gravity, although he was unable to say what gravity was (we are still unable to work this out).

Then, after the stunning inventions of the 18th and 19th centuries, including the steam engine and electricity, we encounter the profound and wholly non-intuitive equation of Einstein that energy is equal to mass times the speed of light squared. Not something you could have dreamed up by the use of common sense. That equation was a pinnacle of human rationality and scientific imagination, a shining symbol of human intellectual advance.

Both Newton and Einstein showed that the cosmos was governed by some fundamental laws of physics. Or so we thought for a time.

Long before these great inventions there was an even greater invention. This was the invention of money. Without this money, these tokens, even buying a loaf of bread would not be practical, especially if you were in a hurry. You therefore avoided the need to barter eggs or a sardine or a knitted sock each time.

Once money was invented it was necessary to have somewhere safe to put it. Hence the founding of banks. Once there is a means of exchange, then there have to be banks. It is much easier and safer to transfer money from bank account to bank account than to hand over a sackful of notes.

Banks in turn were an ingenious invention. The banks soon found that they could use other people's money by lending it to borrowers. When one switches on the light, the light comes on. It comes on because there is a power station. The power station is often built out of bank money. The bank money derives from the savings of the depositors, that is, the citizens. So it is the citizens' money which makes it possible to switch on the light.

When you are young, you could live in a tent on the mud flats by the river. You could have your dinner by the river, you could wash in the river, and the kids could play in the mud. When you had saved up enough money and were in the autumn of your life, you could buy a chateau on the hill and go and live there instead, for a happy retirement away from the mud.

Alternatively, you could right at the beginning borrow somebody else's money from the banks and buy the chateau on the hill right away. Of course you have to pay back this money because it is somebody else's. But at least you do not have to live in a tent in the mud.

So it is with hospitals, schools, roads, ships, cars, factories, offices, palaces, towns, and all the other creations we have. Credit produces them now rather than later.

Banks are not the only suppliers of credit. The other main form of credit is the bond issue where the lenders are insurance companies, pension funds and mutual funds which purchase the bonds as investors. In most countries most medium-term credit comes from banks – more than 90% in some countries. In a few countries the debt capital markets provide more credit than the banks, eg the United States.

Banks and capital markets are therefore like lakes that gather up the droplets of peoples' savings and their stores of value. They use the water to irrigate the land. You need a large body of water to do this, not just droplets. It is the huge pooling of the results of the work of the people which does this. Much water is wasted. But then many people waste their lives and this is not unreasonable.

If one strips away all the veils of incorporation and all the creative figments of the legal imagination, the real creditor is ultimately the individual who places his or her savings with a bank as a depositor or who pays insurance premiums to an insurance company. There is an ultimate see-through to the individual. In the end it is the individual savers who are the collective lenders to the power station and to the dwellers in the chateau on the hill.

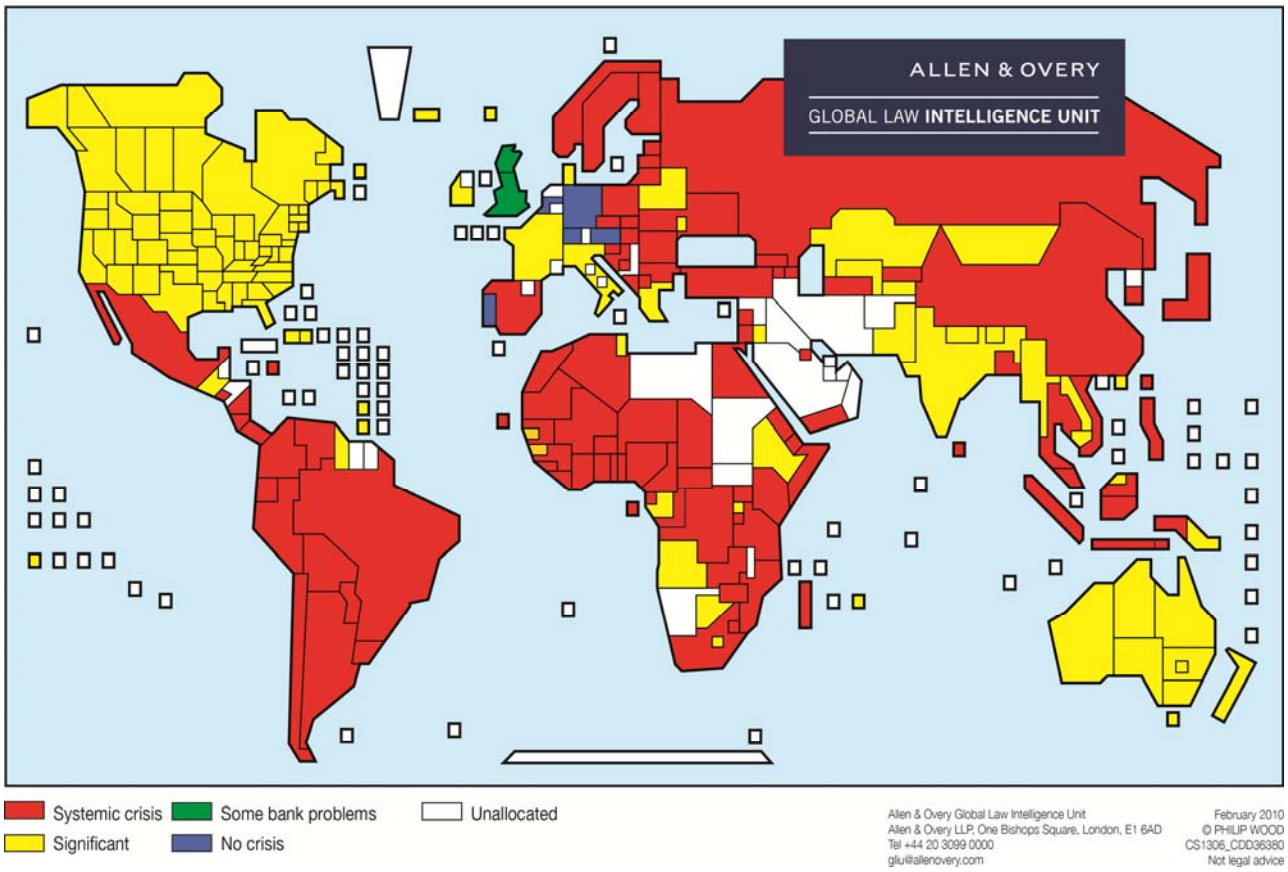
There is no question that this arrangement is ultimately beneficial. The idea that creditors should share their savings with debtors is a good idea. For one thing it gets a roof over our heads.

Banks and disasters

But like many useful inventions, credit has its dangers. The biggest danger is that in the worst case credit can lead to catastrophic collapses of the whole banking system. That annihilates the savings of creditors and it annihilates the debtors who rely on savings to finance their enterprises.

The map "**Bank insolvencies 1980-2005**" below shows international bank insolvencies over the 25-year period 1980-2005, ie before the onset of the financial crisis in 2007-8. Red is a systemic crisis. Yellow is a major crisis, although not resulting in the collapse of the whole banking system.

Bank insolvencies 1980-2005



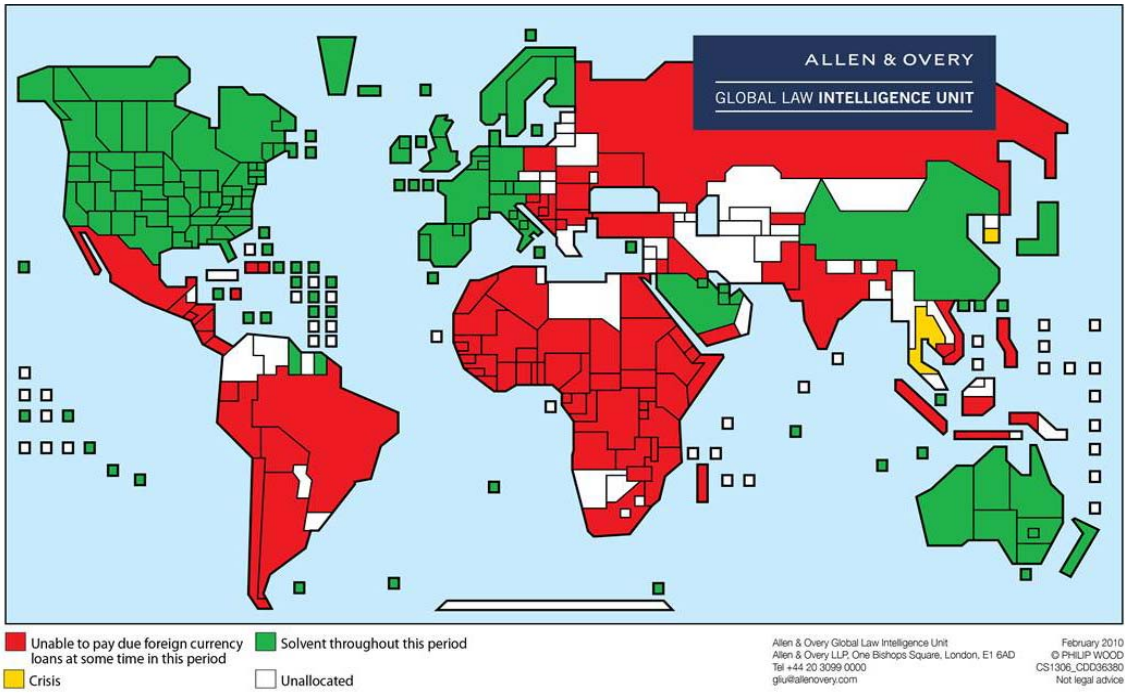
The map shows that very few countries escaped a banking crisis over the quarter century concerned. If we were to update the map to cover the present financial crisis, virtually no country with any serious banking system avoided an expensive disaster.

This dramatic and shocking map asks a crucial question – why do these things happen? It is the answer to this which is critical to the underlying impulse for laws which themselves create legal risk.

The question of the mix of the various causes, the proportions in which they contributed to the particular debacle, and also the question of which causes were direct and immediate, which were in the middle distance and which were remote and ancient; all these questions are not so easy and are much argued about.

Yet we can say that many systemic bank collapses shown on the map were caused by the insolvency of the sovereign state or by the imprudent political direction of bank loans by governments or by disastrous macro-economic policies, leading to inflation, currency collapses, gyrations in interest rates and money supply, excessive borrowing by governments and the build-up of bubbles which the central bank should have stopped. In other words, most of them were caused by bad government, defective politics, and populist or imprudent monetary policy. For example, about half the world's states were insolvent at some time over the same period of 25 years – an event which usually bankrupts the banking system and an event which usually starts with government profligacy. See the map "**State insolvency 1980-2005**" below.

State insolvency 1980-2005



In many cases the flames were fanned by the banks and irresponsible banking. Collapses caused by deliberate bank fraud have been minimal.

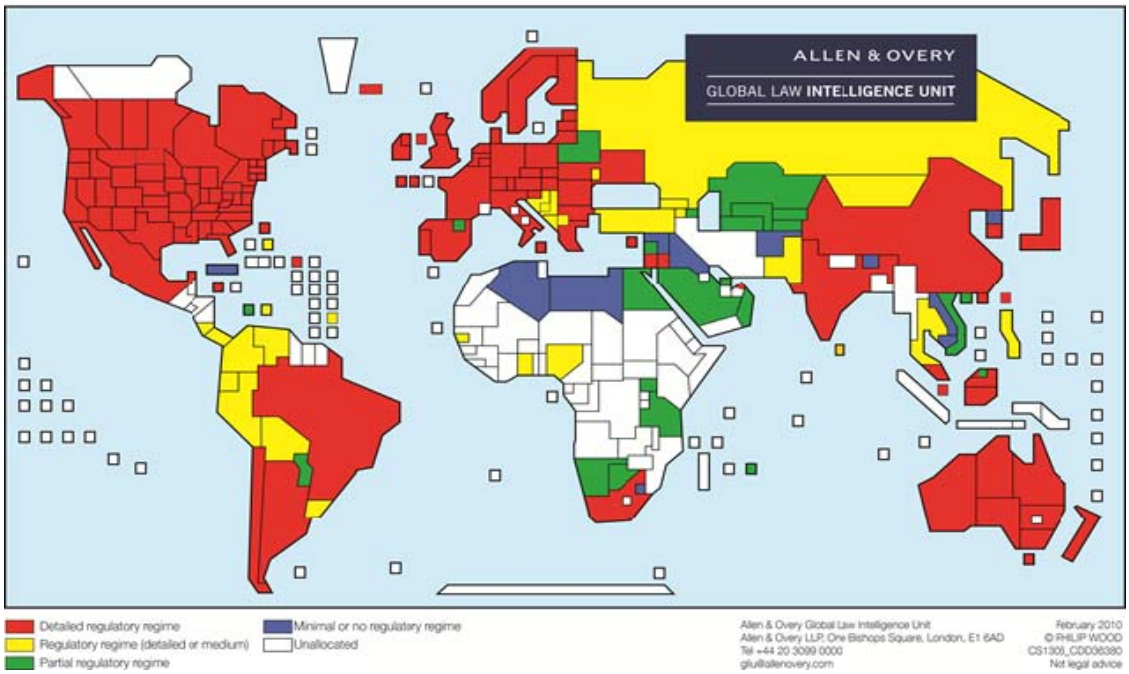
In numerous cases, the whole society was in one way or another, directly or indirectly, involved in the failure. If you really want to know who was to blame, you just had to look in the mirror.

In just about all of the situations, like many scientific inventions, the crisis emphasised the basic design defect at the heart of the idea of a bank. This is that their deposits are short-term or on demand while most of their loans are medium-term or illiquid and so cannot be sold or collected quickly enough to satisfy a panicky run on the bank – the "maturity mismatch". At the core of the structure of the bank there is this fault, this fatal instability in the foundation.

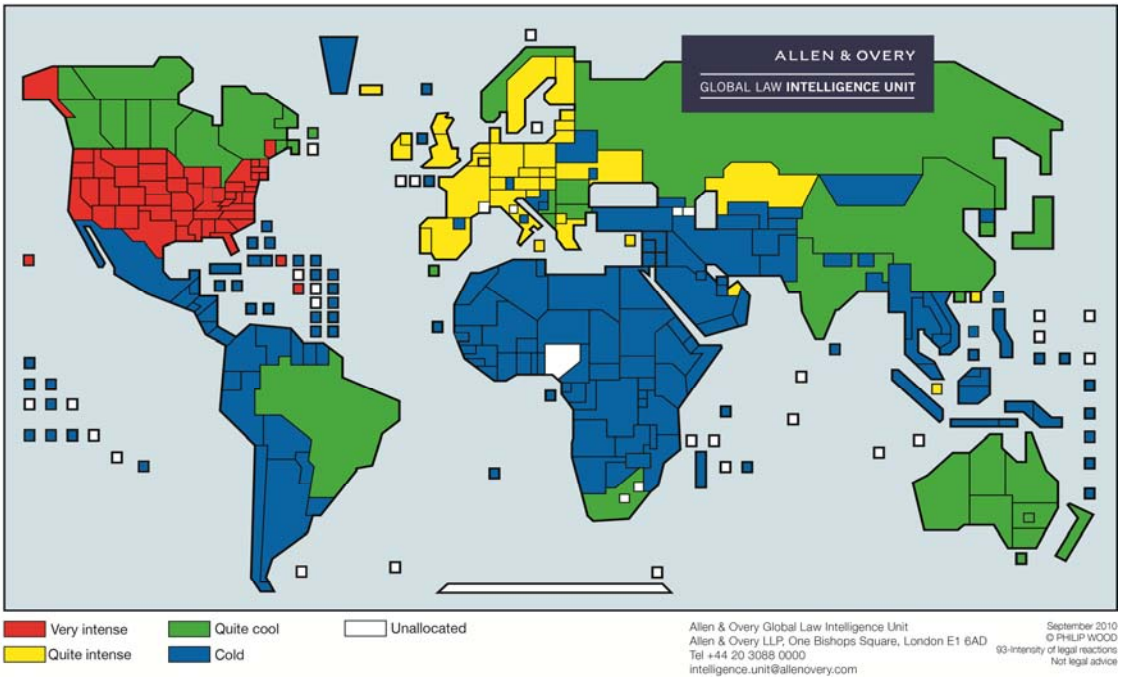
In any event the essential point is that the bankruptcy of banks invariably led to an intensification of the regulation of banks, an intensification of the law, and hence an increase in the amount of law.

This is shown by our two maps which are a snapshot of then and now. The map "**Intensity of financial regulatory regimes pre-crisis in 2006**" shows impressionistically a colour-coded heat map of the intensity of regulation before the financial crisis which commenced 2007-2008. Red is hot, blue is cold. Yellow and green are in between. Intensity includes such matters as complexity, volume and vigour of enforcement.

Intensity of financial regulatory regimes pre-crisis in 2006



The following map "**Intensity of legal reactions to the financial crisis as of 2013**" shows the intensity of regulatory changes in response to the 2007 crisis.



Of course these maps are impressionistic, chain-saw, but they show the general picture well enough. It would follow therefore that imprudent macro-economic policies or bad banking or both often lead to a crisis which in turn leads to the insolvency of banks which in turn leads to more law which in turn leads to more legal risk. This is especially so in view of the criminalisation of the law which is a typical feature of financial regulatory regimes.

This before and after view raises other profound questions. The intense pre-crisis regimes typical of western countries did not avert the crisis. They did not work. In fact the crisis was ignited in some of the countries which had the most intense regulation in the world, eg the United States. It almost seems that the more regulation you had, the more virulent the catastrophe. So does history just repeat the same old mistakes? Do we improve survival risk simply by waving the legal wand and increasing the legal risk suffered by the victims of the legal regime?

The more intense the regulatory regime, the larger the number of rules and the more complicated the restrictions, then the greater is the risk of violations and of punishments, whether criminal or in the form of damages, meted out to the banks and their management. Recent instances have demonstrated that these sanctions can be truly enormous, running to billions of dollars, and have a very adverse effect on the value of the shares of the bank.

It is not just the bank which is being punished. It is also the depositors with banks who are being punished since it is their money which is being used to pay the fines and damages. Similarly it is their shares held by their pension funds or insurance companies which are depleted by the collapse in the share price of the bank. These concealed impacts are rendered even more dangerous by the fact that they are hidden, not known to the general public who do not understand that the general public is paying for the consequences of legal risk. The legal risk flows through to, and silently and surreptitiously impacts, the citizen, the public at large. The citizen pays.

What do corporations do?

Apart from money and banks, another enormously important invention was the invention of the corporation. Although corporations were heard of long before the 19th century and go back perhaps even to Roman times, it was only in the 19th century that the corporate form became generally available and generally used as a vehicle for business.

Banks are also corporations. We refer in this section to non-financial corporations.

A corporation is a figment of the legal imagination. It is a mark in a registrar's book, a creature without a physical being or substance. You cannot taste, feel or smell a corporation. It is a ghost, a phantasm, a disembodied spirit.

A corporation is an idea. But the idea is an extremely simple and beneficial one. The idea is that a business should be carried on in such a way that those who provide the capital for the business by way of shares or bonds or loans are not liable for the debts of the corporation – otherwise the investors would never invest in the corporation because of the risks they could not manage or control – and the corporation itself is the only person legally responsible for claims against it. The corporation also owns all the assets of the business in its own name: they do not belong to the shareholders or creditors. If they did, it would be impossible to get consent from everybody to sell or mortgage the assets, and it would be impossible to deal with the situation if one of the shareholders or lenders became bankrupt so that its share had to be realised. It would be completely unrealistic for the shareholders and investors themselves to deal with the assets and accompanying liabilities.

The twin ideas of the limited liability of investors and the ownership by the legal corporation of its assets and liabilities was crucial to the development of business.

Ordinary corporations do everything. They manufacture goods, from chocolate to cars. They operate mines. They refine and produce oil and gas. They carry out construction. They run hotels and offices. They have shops, they operate aeroplanes and trains. They produce chemicals and medicines. They produce food and healthcare equipment and services. They offer tours and leisure travel. They run newspapers or publish books. They own land. They run telecommunication networks and produce computers. They run water or gas companies. They are banks or insurance companies.

In developed countries, corporations are the main vehicles of our entire economies.

However, as with banks, non-bank corporations also became bankrupt, eg because the market for their products failed or because they borrowed too much, albeit because there was an economic depression, or because they were hit by a domino bankruptcy of some other corporation.

Hence these bankruptcies in turn led to an increase in the volume of law and regulation mainly intended to reduce the risk of bankruptcy and hence of a loss to individuals and other corporations and ultimately significant losses to whole economies if the corporation was large enough.

If a major corporation fails, then, as with banks, the reaction of legislators is to wave the legal wand. Typical of the areas of law are bankruptcy law generally, the regulation of prospectuses offering securities to the public, the regulation of financial statements, the listing rules of stock exchanges which list the company's securities and the upgrading of concepts of corporate governance and the like. An example is the legislative reaction to the failure of Enron in 2001, namely the Sarbanes-Oxley Act of 2002.

Because corporations do everything, so they attract the regulation of everything, eg product liability, health and safety rules, employee protections, anti-trust and competition rules, the regulation of food and drugs, the

regulation of transportation and advertising. Corporations are therefore one of the main targets of the law and hence of legal risk.

Popular resentment

Apart from the practical importance of banks and corporations to economies and the potentially catastrophic effect if they should become bankrupt, the legal regime governing banks and corporations and hence their legal risks are often driven by another human factor. This is the rancour and resentment felt by many towards those who are wealthy or who are in positions of power, often embodied or represented by banks and large corporations and big business in general. The result is that, whether in democracies or in dictatorships, the desire of politicians to curb the power and wealth of banks and corporations often leads them to promote laws which harden the legal regime applying to banks and corporations and hence increase their legal risks. Particularly in times of crisis these laws get an easy passage through the legislature to please the people.

Money, banks and corporations in the hierarchy of legal needs

The significance of money, banks and corporations may be illustrated by a hierarchy of legal needs based on the concept of a hierarchy developed in 1954 by the famous American psychologist, Abraham Maslow.

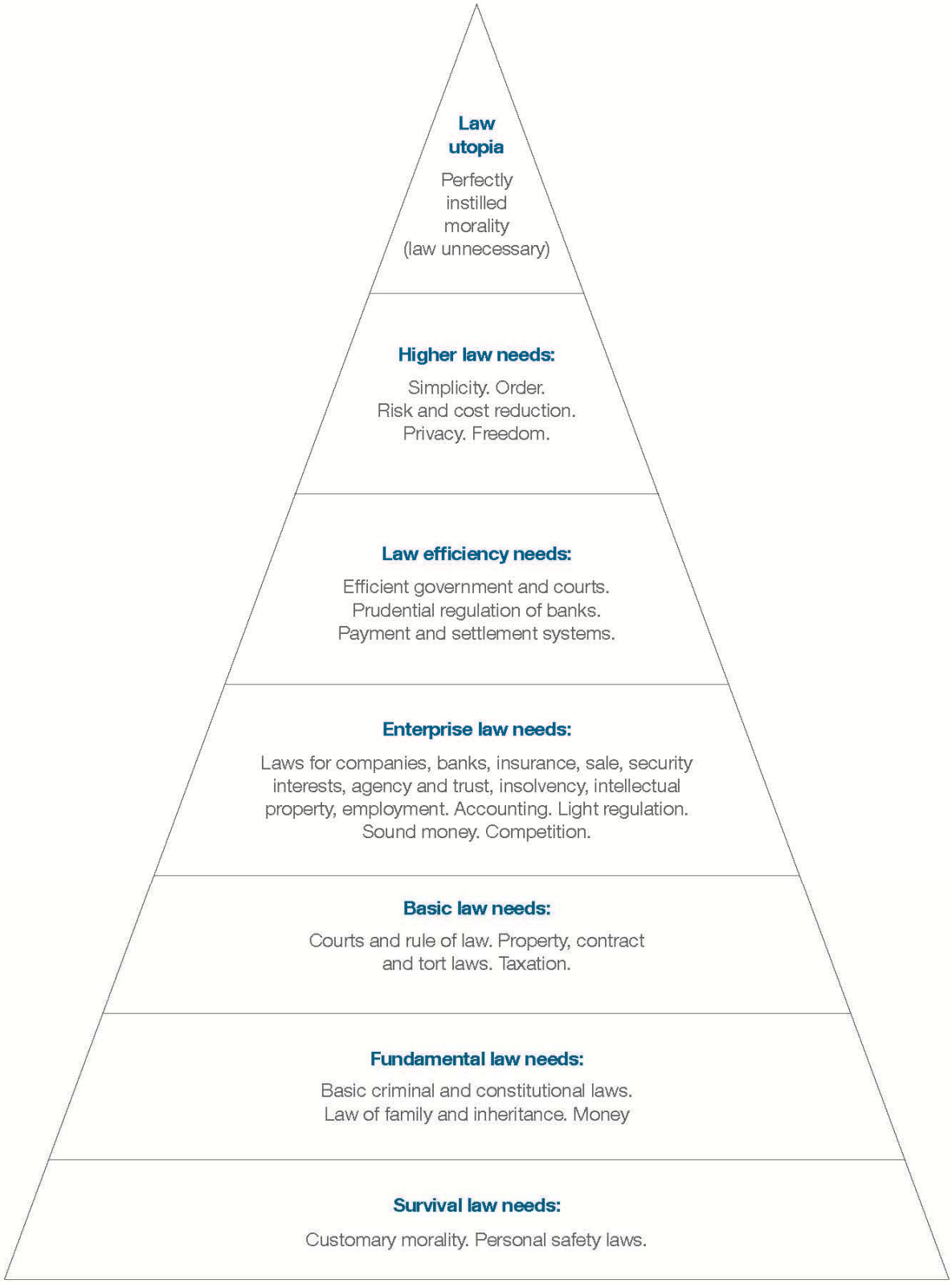
Abraham Maslow produced the celebrated Hierarchy of Human Needs which showed his view of the ranking of human needs from the most basic and fundamental to the most refined and sophisticated.

At the base of the triangle were physiological needs, which he designated as food, water and oxygen. These were the needs which were absolutely necessary for survival of the organism. Then one step up were safety needs which were designated as comfort, security and freedom from fear. The next step up were belongingness and love needs which were named as affiliation, acceptance and belongingness, ie the satisfaction of basic human desires. The hierarchy then moved upwards through esteem needs, cognitive needs, aesthetic needs, and self actualisation.

At the peak of the triangle's hierarchy were "peak experiences" which were evidently not of the "Puff the magic dragon" category, but higher spiritual states of awareness of the type experienced by ecstatic religious mystics, presumably.

Similar principles of the hierarchy can be used in relation to legal needs, as shown in the chart "**Hierarchy of legal needs**".

Hierarchy of legal needs



After Maslow 1954

The most fundamental and primitive of legal needs are those which go directly to survival, such as customary morality and personal safety laws.

Fundamental law needs at level 2 include basic criminal and constitutional laws and laws of family, sex and inheritance. We would include money and its attendant law in this range or step, ie money appears at a fundamental level as a basis of societies in the sense that modern society goes nowhere if it does not have money.

Above this are basic law needs, at level 3, such as courts and the rule of law, property, contract and court laws and taxation. Already we are in the sphere of commercial and business law.

Enterprise law needs appear next about half-way up the hierarchy, at level 4. This category would include laws for companies, banks and insurance. This would include accounting and sound money. It would also include bankruptcy or insolvency laws, as well as laws relating to employment and competition.

It is sometimes said that lawyers who deal in financial assets are involved with something which is intangible, invisible and therefore sterile. But unlike other classes of asset, financial assets do not exist without two people, eg a lender and a borrower, a bank and a depositor, a shareholder and a company, a seller and a buyer. The asset does not exist without the people at either end, circling each other with a mixture of suspicion and admiration. The result is that all of the passions, hopes and fears of the counterparties are built into the asset and it is those emotions which create so many tensions in the room.

The hierarchy would then proceed up through law efficiency needs, at level 5, such as efficient government and courts, through to higher law needs, at level 6, which I designate as simplicity, order, risk and cost reduction, privacy and freedom.

Finally, at the top of the hierarchy in the peak of the triangle, at level 7, there would, as with Maslow, be a utopia, in this case a law utopia. In view of the inherent restrictiveness of the law, it seems reasonable to propose that a law utopia would be a society where everybody has a perfect instilled morality which everybody instinctively obeys, where law in its formal and written form is unnecessary, where there should be no need for enforcement by the authorities.

Maslow's peak experience takes us outside ourselves. Our peak takes us outside law into natural morality.

We need not, however, hold our breath in case this society should ever materialise. Indeed for reasons to be discussed next, the sheer size and intensiveness of law could well increase. Things could get worse.

This hierarchy demonstrates a fundamental point. The survival motive of law applies to many banks and corporations. These areas of the law are central to our societies. Good law applicable to them improves us all. Bad or excessive law prejudices us all.

Chapter 4

Risks from the growth and complexity of law

Growth and complexity of law generally

Many people complain of the sheer size of the law, although fewer people probably realise how dramatic the growth in size and complexity of the law has been if we stand back with a big historical view. This disproportionate increase in size and complexity of the legal regime makes the law inaccessible and therefore directly causes unwarranted legal risk.

If an expert is required to understand and comprehend even a tiny sliver of law, such as whether banks can carry out proprietary trading in the jurisdiction, it is hard and very expensive to get together all the experts necessary to understand about the implications of even a single large transaction, let alone measure their weight and importance in relation to all of the other factors or to work out how they relate and fit together internationally.

For example, it is difficult to put together a team of experts to cover all aspects of, say, a loan to finance the acquisition of a large group of companies where the target parent has subsidiaries in, say, 80-100 different countries – which would not be wholly abnormal. Some of the key issues would be:

- Whether there is a withholding tax on interest payable under a direct loan to a foreign subsidiary of the target by the members of the lending syndicate.
- Whether each member of the target group can guarantee a bank loan to the acquirer to finance the purchase price paid by the acquirer and grant security for the guarantee of the loan or whether this is prevented by a ban on the granting of financial assistance by a company for the purchase of its own shares.
- The availability and strength of security interests to secure the guarantees and to secure the direct loans.
- The risk that securities and guarantees could be set aside as a preference on the insolvency of the target group.
- Whether there are any merger filing obligations and what they are in each of the countries concerned.

- Whether there are any legal restrictions applying to a foreign company purchasing or acquiring an indirect interest in the company in the jurisdiction concerned.
- Whether there are employee problems, eg whether employees can block a merger or whether employees of the targets are automatically transferred to a company purchasing the business.
- Whether the directors are risking personal liability because the deal is speculative.

These are only some of the factors which would have to be checked by experts. Since nearly all of them would involve most or all of the jurisdictions concerned, one can see that the measurement of legal risk is an obstacle. The bidder and its banks would often have to close their eyes and hope for the best. In other words, the precise measurement of legal risk in order to price the legal risk may not be feasible at all.

One could easily double or triple the main legal risks embedded in the transaction.

Number of jurisdictions

It is evident from the above example that the threshold risk in a fairly routine international transaction is the sheer number of jurisdictions involved.

Altogether there are about 320 jurisdictions. Even though the number of jurisdictions now is tiny compared to the Middle Ages where a single country could have thousands of cities, municipalities and villages or provinces, each having their own customs and laws, the realities of modern interconnectedness between jurisdictions means that the intensity of legal risk has increased.

Large banks and ordinary corporations often sell their products or have customers in virtually all of the jurisdictions in the world and indeed often have branches or representative offices in one-third or one-half of them. So they have to take into account the laws of all of the jurisdictions in which they do business. Until fairly recently most business was conducted between a much smaller number of jurisdictions. Large countries such as the USSR and China were effectively hermetically closed economies with minimal direct contact with other countries other than through their state-owned banks and state-owned entities. Large regions in the rest of the planet were excluded because of their poverty and also their closed economies, eg many countries in Africa, Asia and Latin America.

But now practically every country has opened its economy to a large degree, practically every country is now part of the world economy, from Abu Dhabi and Albania through to Yemen and Zambia. Indeed it is hard to think of any country which has not got aspirations in this direction and which is completely sealed off from the rest of the world, other than North Korea.

Tiering

The second factor which increases the legal risk because of the size of the law is the tiering of domestic legal systems. The legal systems in developed countries are like slicing through the crust of the earth to reveal layers of sand, chalk, granite and gravel.

For example, English law has about eight classes of security interest in the sense of core mortgages and charges, ranging from the regime applicable to security interests used in payment and security settlement systems through to the security interest which individuals can give.

8 x 320 = 2,560

The UK also has around 25 insolvency regimes for different classes of entity. It is true that some of these are fairly minor and rarely used, eg the insolvency regime for water utilities, but the separate regimes for, say, commercial banks and investment banks are enormously important. So here the original tiering typical of most legal systems between the law applicable to individuals and that applicable to businesses has been endlessly sub-divided.

25 x 320 = 8,000

Some of this tiering is due to the simple increase in the number and diversity of businesses, but it also is attributable to politics. For example, in democracies there is a constant tug-of-war going on between the protection of businesses, who do not have votes, and the protection of individuals, who do. The result is that the protections for individuals or small businesses are enlarged. This means that payment systems, for example, have to be carved out and exempted from the protective tendency because of the large amounts involved and the catastrophic impact if a security interest, say, should turn out to be invalid or difficult to enforce because of a rule protecting individual borrowers or homeowners.

Extraterritorial laws

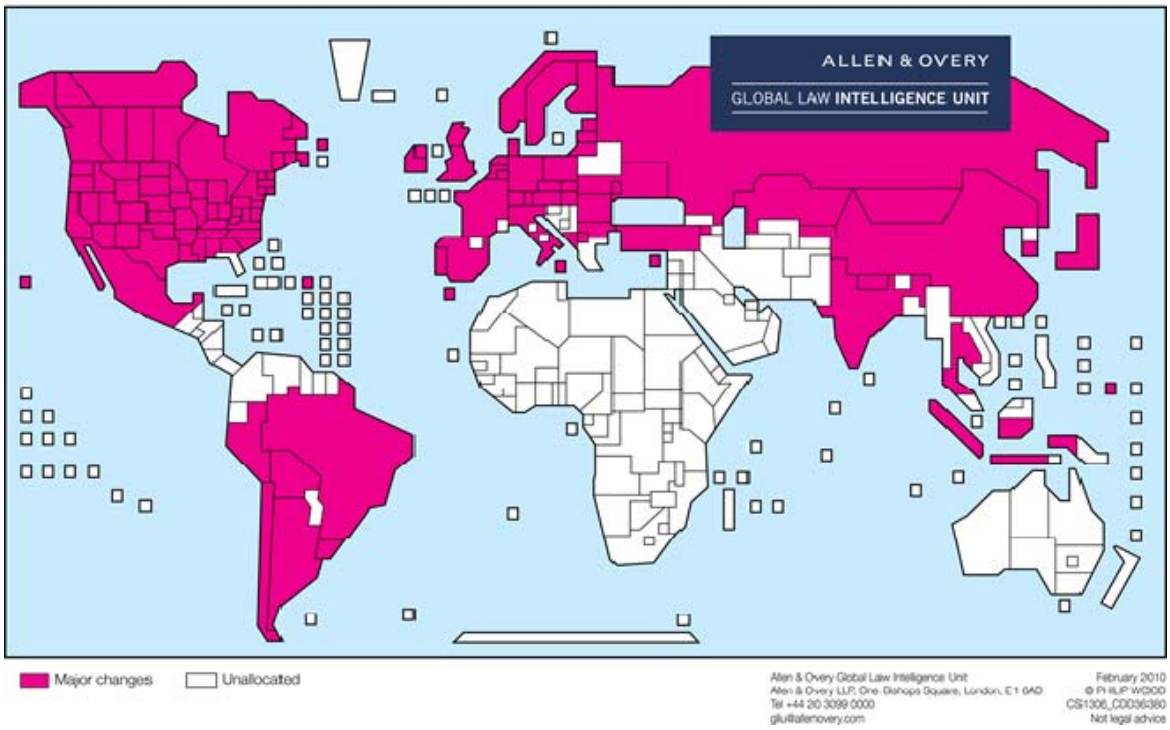
Apart from this internal tiering, there is the layering caused by extraterritorial risks. Because many countries, especially in the developed world, give their laws extraterritorial effect, the transactor may have to have regard, not only to the laws of his or her own jurisdiction but also the laws of one or more other jurisdictions which have contact, often very ephemeral and slight, with the transaction. Extraterritorial risks are considered later.

It will also be shown later that businesses with international operations can land up in courts practically anywhere because of the wide and exorbitant jurisdictional rules of most countries.

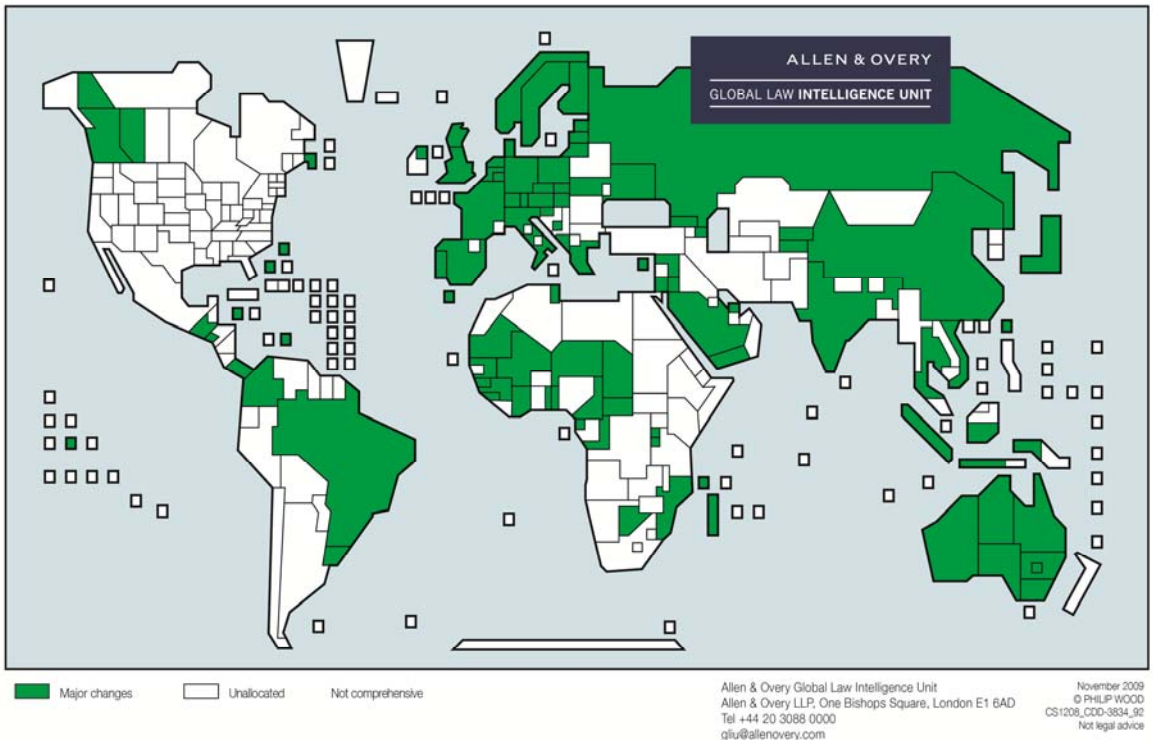
Rapidity of change

The law in many countries is mercurial and volatile. This is dramatically illustrated by two maps, the first on "**Major Changes to insolvency legislation 1997-2007**" and the second on "**Major changes to company law 2000-2009**".

Major changes to insolvency legislation 1997-2007



Major changes to company law 2000-2009



These maps are not exhaustive and not all countries were checked but they do show that most countries had material changes to important arenas of law in a ten-year period. The reason for this is attributable to underlying factors which are discussed in a moment, to do with the growth of wealth and GDP.

How much is a million, a billion and a trillion?

Since we are getting into figures, it is worth getting a feel at this stage for what is meant by a trillion.

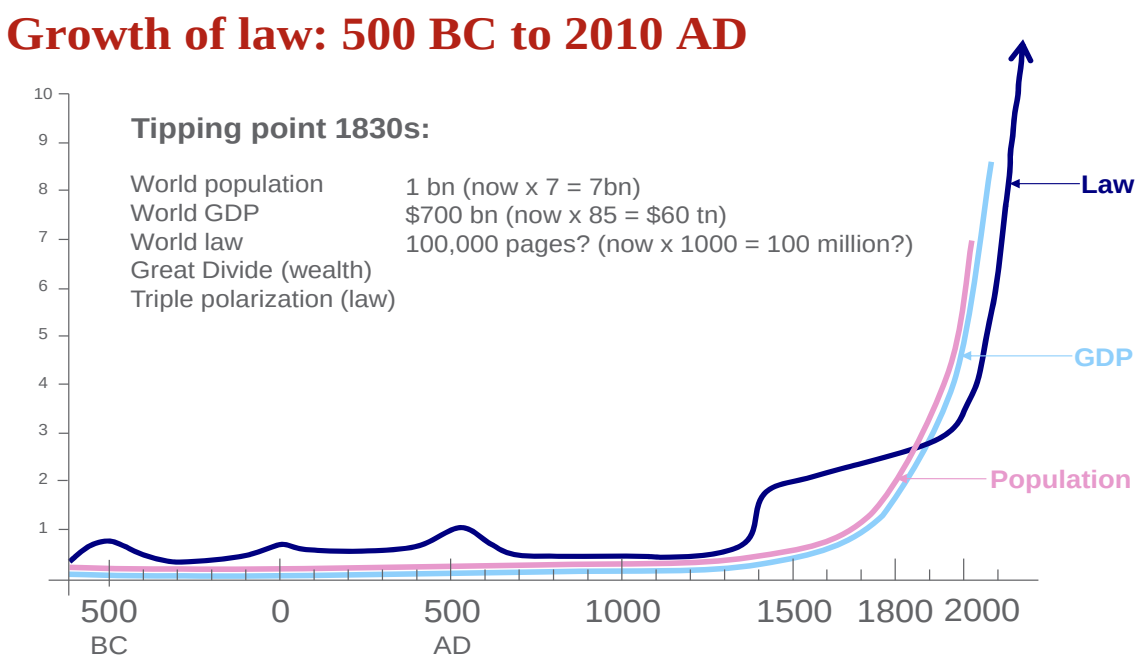
> A **million** is a square piece of graph paper, as wide as a child's arms stretched out, finger point to finger point, a metre. A metre is a long step of the foot.
>
> A **billion** is that piece of paper a kilometre to the side – just over half a mile.
>
> A **trillion** is that piece of graph paper a kilometre to the side and a kilometre up.

So a billion is much bigger than a million and a trillion is much, much bigger than a billion. A trillion is an enormous figure.

Growth of law

People often talk about the increase of the stress in their lives, the traffic, the congestion, the crowds, the trains, the effort to do simple things. Although they register these things, the fact is that the public generally have no idea what a massive upheaval has been going on if we view things over a longer term and how gigantic the changes are and how even more gigantic they are likely to become in our lives.

The first chart to look at is the "**Growth of law**" chart which tracks the growth of law since 500 BC against the growth of population and the growth of GDP.



Population scale 1 = 1bn people | GDP scale 1 = US$1 trillion | Law scale 1 = 100,000 pages

This chart shows that since 500 BC relatively not much happened in the growth of law until around 1830 when the volume of the law took off.

The chart explores why this should be so and indeed demonstrates a simple progression. It shows that as population increases, so does wealth go up, and so does the growth of law.

Around 8,000 BC the world population may have been around ten million, about the population of today's Paris. By 1 AD it seems to have been about 250 million, not much more than present-day Indonesia. In 1830 it was around one billion. It took 100 years to get to two billion (1930), but then just 30 years to reach three billion (1960), half that – 17 years – to reach four billion (1977), 13 years to reach five billion (1990) and the even shorter time of ten years to reach six billion (2000). Now we are over seven billion.

So if one draws a line at representing population from 1 AD, nearly all of the line represents population growth since 1830 as shown in the above chart. In other words population was pretty static in gross terms until 1830 when it really took off at a massively accelerating pace. The population line grovels around at the bottom of the chart until this point when it suddenly shoots up almost vertically.

Around 1830 there was a similar dramatic upward shift in wealth, as measured by gross domestic product.

By 1 AD world GDP (in 1990 adjusted U.S. dollars) was around $100 billion, about the GDP of present day Hungary or New Zealand. Around 1830 it was $700 billion, broadly equivalent to, say, Australia or South Korea in the mid 2000s. By 1975 it was $16 trillion (more than 20 times as much) and it more than doubled to over $37 trillion by 2001. Now it is over $70 trillion.

Again if one draws a line representing GDP growth from 1 AD, as shown in the chart, the GDP would again cling closely to the bottom of the chart until around 1830 when suddenly it lifts off and accelerates upward.

Per capita GDP in 1 AD worldwide was about $500, less than that of present-day Burundi, Malawi or Sierra Leone, ie less than that of the world's poorest countries today. By 1830 it was $700 but by 1975 it was $4,000, and $6,000 by 2001. So virtually all the growth has been since 1830.

In 1 AD and even by 1830, most people worked on the land. Now usually more than 80% of the population of advanced countries is urban, with the tiny amount of around 1% or 2% engaged in agriculture. Typically in these countries, the contribution of agriculture to GDP is around 1%, of industry around 27% and the remaining 72% comprised of services – banking, insurance, retail, construction etc.

It is obvious therefore that there have been staggering changes since about 1830 which have resulted in a huge amount of money in circulation and in the amount of credit.

Just to keep it simple, one has to focus on some very simple arithmetical figures, the basic statistics.

Since 1830 world population grew seven times. That is, for every one person in 1830 standing next to you on a train or in the elevator, there are now seven people.

Over the same period world GDP grew by 85 times. This means that for every person who in 1830 had $100 in his or her pockets or purse (adjusted for inflation) that person now has $8,500 – quite a lot more. That money would either have to be in much bigger notes or else, as one would expect, be deposited in the bank.

How much has the law grown since then? This is extraordinarily difficult to measure but I suggest that the growth of law since 1830 has been between 1,000 and 100,000 times. It probably does not really matter that we cannot be precise, since it is evident that there was a huge surge upwards from the early 19th century.

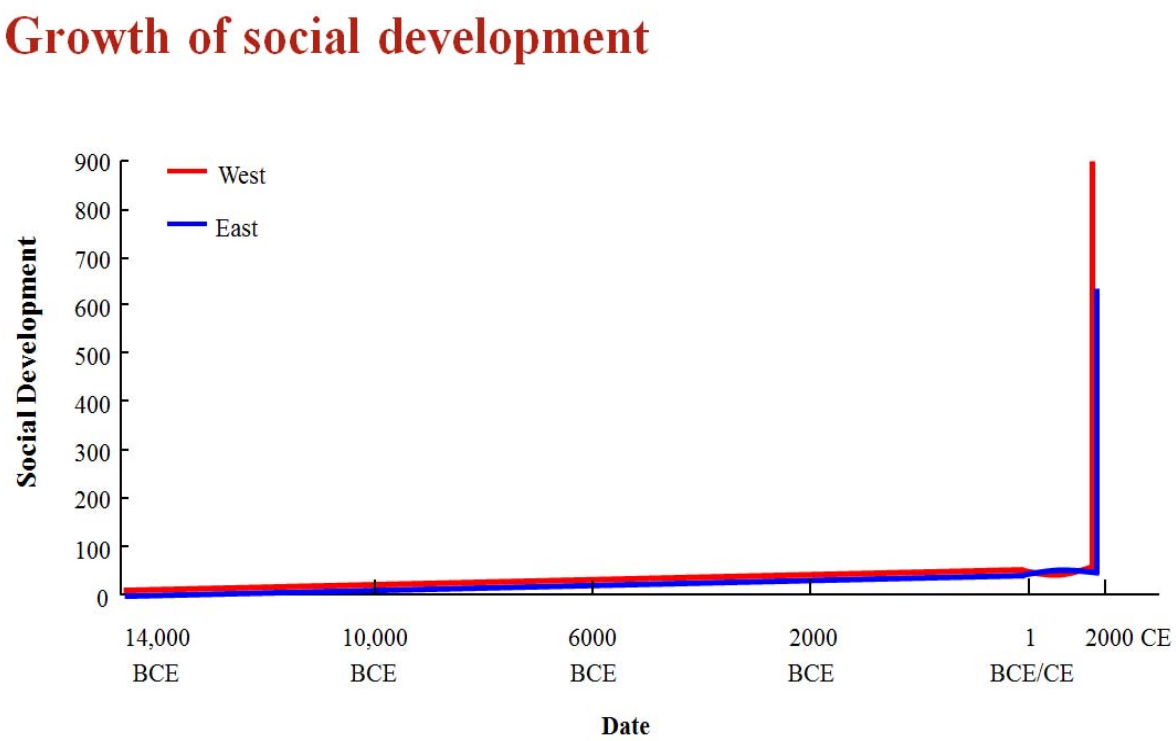
The line representing growth of law in the chart is only tentative and impressionistic. It is based on the fact that back in 500 BC, the content of law, at least written law, seemed rather small. Hammurabi's code of more than 1,000 years earlier in 1772 BC, which is contained on the 2.25 metre (7.4 feet) stele now in the Louvre in Paris, contains 282 rules of law. Hammurabi was a Babylonian king. The early Romans were reputed to have had Twelve Tables. The laws in Leviticus, in the biblical Old Testament, amount to an impressive number of articles, but tiny compared to modern legislation.

We can work out the length of the codes of Justinian codifying Roman law around 500 AD and we can measure the barbarian codes of following centuries in the dark ages. When a collection of all current laws in Castile was printed at the king's command in 1569, it filled only two volumes, albeit there were 4000 laws. In the next 100 years or so there was a proliferation of local codes in Europe. We can also measure the size of the codes in the early codification movement, starting in France in 1803. We can measure the size of U.S. tax law in the 19th century as against the size of U.S. tax law now. We know that prior to the 19th century, company law hardly existed and there was no such thing as securities or financial regulation, let alone the other fields of regulation which now are monsters on the legal landscape. So it does not seem too unreasonable to estimate that the growth of law is well in excess of 1,000 times larger since the early 19th century and could in fact be much, much larger.

The chart on the growth of law shows a slight rise at the time of the Greeks and the early Romans, a rise at the time of the first great philosophers or religious leaders, such as Siddhartha Gautama (Buddhism) and Confucius, both of whom died round about 480 BC, a further rise at the time of Justinian's codification of Roman law (534 AD) and the Koran, which was written in about 650 AD and which contained a law code, a sharper upwards movement at the time of the Renaissance and then virtually a vertical line upwards from 1830 onwards.

The chart on the growth of law is indirectly endorsed by the work of social anthropologists and world historians.

An example is the chart "**Growth of social development**" based on a chart in Ian Morris' "Why the West Rules: For Now" (Profile Books, 2010) p 161. The chart shows social development in the West (coloured red) and in the East (coloured blue) since 14,000 BC.



Source: Ian Morris "Why the West rules: for now" (Profile Books) 2010.

The lines on the chart are built up out of four variables. The first variable or trait is energy capture. Energy capture includes such things as extracting energy from plants and animals to feed ourselves, and capturing energy from wind and coal and from explosives. Energy capture is considered so fundamental to social development that in 1940 the celebrated anthropologist Leslie White proposed reducing all human history to a single equation: E x T → C. E stands for Energy, T for Technology and C for Culture.

The simplest way to think about energy capture is in terms of consumption per person, measured in kilo calories per day. For example in the year 2000 the average American burned through some 228,000 kilo calories per day.

The second trait is organisational ability for which Ian Morris uses a proxy, closely related to organisational capacity but easier to measure. The one chosen is urbanism because the organisation needed to keep a city going is vastly beyond anything earlier societies could have managed. Running Lagos with a population of 11 million or Tokyo with a population of 35 million would have been far beyond the Roman Empire's capabilities. This is why social scientists regularly use urbanism as a rough guide to organisational capacity.

The third trait included in the calculation is information processing but in its wider sense which includes the ability to process and communicate prodigious amounts of information – the invention of writing, then printing, then computers. Information processing is critical to social development.

The fourth trait is the capacity to make war, where technology has often proved to be the winner.

These traits are not necessarily the only way to measure social development but it is probably true that even if one used different traits to measure similar things, the overall pattern and the overall scores would not change much.

This is chainsaw art but it does not really matter in terms of the overall result.

What the chart shows is that until about 1750 to 1800 social development in both the East and the West was extremely low. Then it suddenly shot up around about 1800. This shows approximately the same development as in my "**Growth of law**" chart mapped against GDP and population.

Predictions for the future growth of law

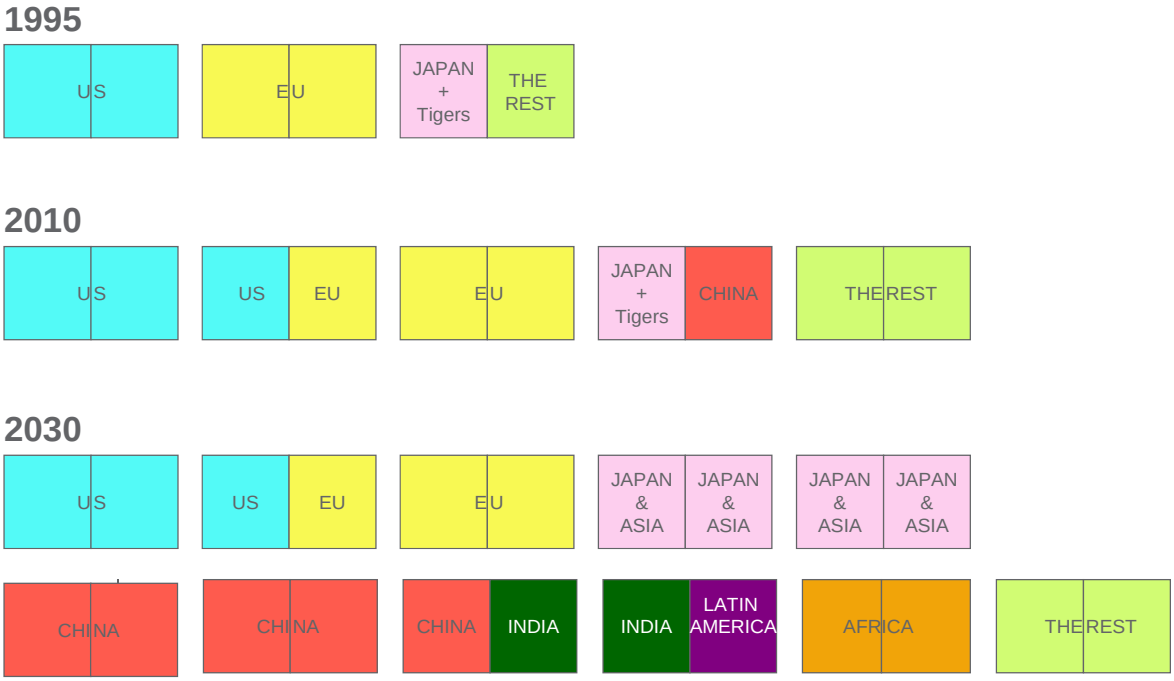
Since it is to the future that we look, it is worth attempting a prediction, a forecast of what might happen over the medium-term as regards the growth of law and the future direction of legal systems. By medium-term, I mean over the next 15 to 20 years, not next year.

Predictions about the future are extremely unsafe. Nobody can tell exactly what will happen in three months, in one week or even tomorrow with certainty. Economists struggle to make economic predictions beyond three months of general trends, let alone the detail. It is obvious therefore that the predictions made here are bound to be unsafe and the real future could be entirely different.

Time future is perhaps contained in time present. Time past forms time present, but the arrow of time changes our perspective of the past. As to the future, we live in Plato's cave and can only see the future as a shadow of a present reality.

If we go back a little in the recent past and use the present to suggest a trajectory we can posit a rough guess of world GDP in 2030. This is shown in the chart "**GDP football fields**".

GDP FOOTBALL FIELDS ($10 trillion)



Each oblong is a football field of $10 trillion.

In 1995, as shown in the chart, world GDP was roughly $30 trillion, ie three football fields. This was weighted in favour of the U.S. and Western Europe, mainly as a result of developments in the 19th and 20th centuries for which many explanations have been attempted. From about 1830 the West pulled away from the rest in terms of technology and GDP so that, of the three football fields, by 1995, the U.S. was one, Europe and its offshoots was the second, and the rest of the world was the third football field. Japan and the Asian Tigers occupied half of the third football field and the rest of the world the other half. Africa at that point had only about 3% of world GDP.

The economic split from 1830 forward is often referred to as the Great Divide. At the same time there was another development, a major development in the context of world law, which is what I call the **Triple Polarisation**, that is, the division of the world into three great families of law and their offshoots. The Triple Polarisation is discussed later, but suffice it to say here that the military and technological dominance of the West from the 19th century onwards meant that Western countries colonised almost the entire world and in countries which they did not colonise, they hugely influenced the legal systems. The result was that out of the 320 jurisdictions in the world, probably more than 250 are based on a Western legal system. That would have been fine, but for the fact that the main Western legal systems were completely different – probably as a result of the timing of their crystallisation in relation to the industrial revolution. More about this later.

If we went back two hundred years, the economic situation would have been in contrast to what it was in 1999 because at one time China had 30% of world GDP, a situation which may well transpire in the future.

In any event, in around about 2010 there were five or six football fields of ten trillion each with China showing marked advances.

By 2030, provided there is no terrible disruptive event in the meantime, economists have predicted a world GDP of around 12 or 15 football fields or even more. So things are really looking up in terms of more food, more health, more power stations, more hospitals and so on for the peoples of the world.

All this extra GDP is not going to go under the mattress in the form of cash. It is going to go into banks, capital markets and funds and in turn be channelled through to corporations.

This in turn should lead to a huge increase in the number and value of transactions, which is incidentally likely to result in more disputes and litigation.

In addition, if three or five football fields can produce the mayhem shown in the map on bank collapses and if they can produce the financial crisis of 2007/2008, surely 12 football fields or even more will produce much more money sloshing around in banks and capital markets, more competition between nation states, much more interconnectedness of countries, and surely this will produce more risk, surely this will point to even more red on the map in coming decades?

Although one must be careful about establishing cause and effect relationships when there is only a correlation, what seems to have happened around 1830 is that, when the population of the world hit the first billion and subsequently accelerated, the increased number of people produced more wealth. Compared to a million people, a billion people think of more things, invent more things, make more things. The result of this prodigious multitude of effort by such a vast number of people produces wealth which is measured by GDP and which goes into banks and capital markets. This wealth in turn is funnelled into corporations by way of investment by share capital, bank loans and bonds. The number and value of transactions, especially credit transactions, increased. Very often large corporations go bankrupt as do large banks, leading to fresh laws to mitigate the consequences and losses suffered from big bankruptcies. The law surrounding regulation, bankruptcy, corporate governance, financial statements and the like receives a huge impetus leading to manifold expansion. Transactions themselves become more complicated to deal with the risks.

We are locked in the present. For us the present minute, the next few hours, the next day, the next week, the next month, these preoccupy us. The presence of the present deadens us to the future. But it is to the future which we must look. That future could produce much more legal risk than we have at the present.

A metric for measuring the size of law

One possible metric which could be used for measuring the size of a legal regime is how many pages of concentrated law a single individual could actually learn in one year.

This metric is what I call a "**uni-year**" which is based on the amount which in my experience a student taking four courses at a postgraduate level, typically an LLM, would learn in a year for the examinations at the end of the year in the four subjects. I base my measures on the amount of notes which I gave to students in courses I taught at Universities of Oxford and Cambridge in the first decade of the 2000s.

As a rough estimate and rule of thumb, I calculated that the most fanatical student, a student who never went out, who never went to the bar, who never said hello, who hardly ever left his or her room and who worked all the time, would learn 1,000 pages of concentrated notes for the examination. By 1,000 pages, I mean not the pages which the student would actually read for the exam – which would be much more in terms of articles in law journals, cases and the like – but the amount of concentrated learning notes necessary to achieve a top mark in an examination at first class standard.

My estimate was that the upper limit was 1,000 pages of notes, which played out at about 250 pages of concentrated notes for each topic. In practice most students actually learnt very much less than this, probably less than 100 pages of synthesised swotting notes in some cases.

If we apply this metric of a uni-year – the amount a very diligent individual could learn in one year of work – we can apply this to the size and dimensions of a particular statute or area of law in concentrated form.

For example the Dodd-Frank Act of 2010 of the United States, which reformed financial and related regulation as a result of the financial crisis of 2007/2008, runs to about 1,000 pages. However as the statute is only an enabling statute to be implemented by regulations, one has to count the volume of the regulations themselves. These are calculated to run from somewhere between 20,000 to 50,000 pages including commentary and explanation. If, just for the sake of the argument, we say that the total amount of U.S. financial regulation, including the Dodd-Frank Act and all of the legislation previously passed, amounts to 100,000 pages, then it follows that this would be 100 uni-years. In other words it would take a particularly dedicated individual 100 years – a century – to learn the financial regulatory regime in the United States. Whether it is a century or just ten years, it is over the top.

And this is only one country and one area of law.

This is why we say that the amount of law is completely disproportionate and that the resulting inaccessibility and incomprehensibility of the law in itself creates legal risks. There is no point in having a law if the people who are subject to the law do not know what it is and cannot conceivably learn it except by a century of effort.

In the regulatory field, there has been a bubble of law. Those who prepare these laws are evidently not good at simple arithmetic and are not knowledgeable about how to count.

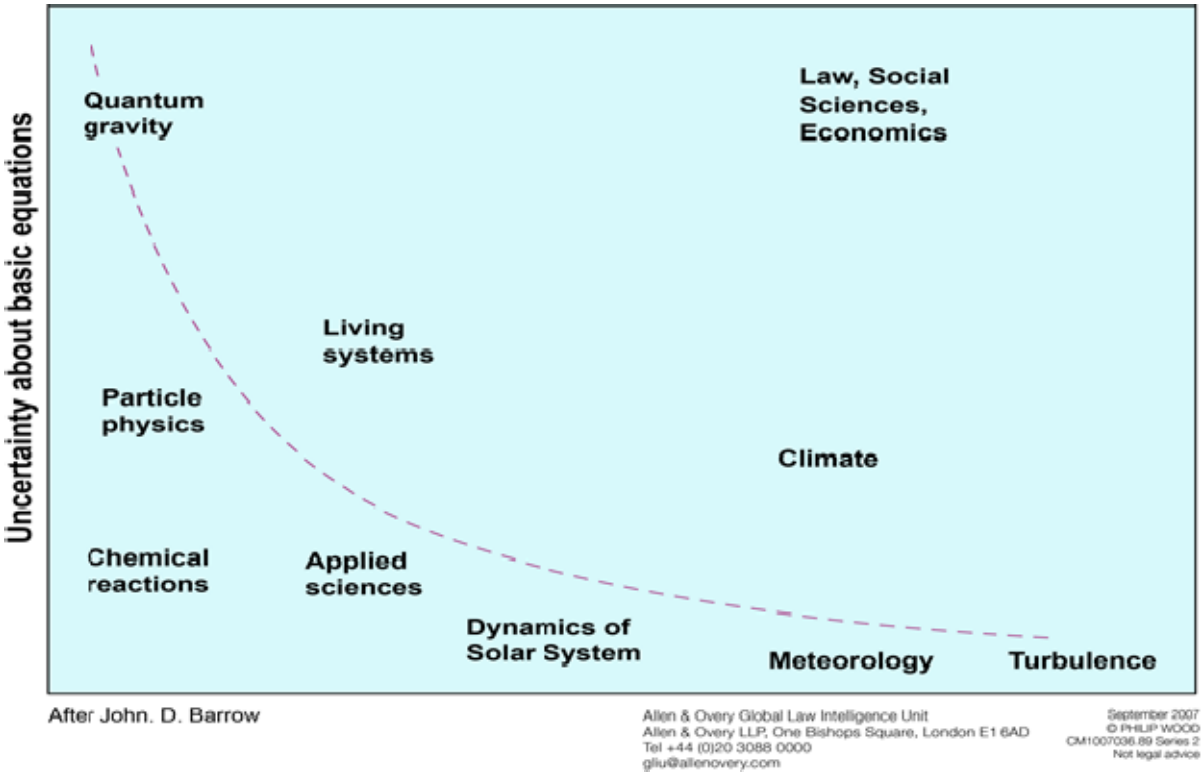
Complexity of the law

It is not just the increase in the size of the law which increases legal risk, but also its complexity.

The law is inherently complex by reason of our uncertainty about cause and effect, disagreements about what the law should say and who it should protect, national cultural differences and histories, and disputes about how much law there should be and how intrusive it should be.

This inherent complexity of the law is shown in the chart "**Complexity of phenomena**" which is based on a similar chart by the English astronomer and physicist Professor John D Barrow (who in turn based his chart on that of David Ruelle).

Complexity of phenomena



The vertical axis in the chart shows the complexity and uncertainty about basic equations. The horizontal axis shows the operation of the equations in the real world. For example, an equation for the speed at which a drop of water will fall is no doubt quite simple but tracking exactly what happens to a particular drop of water falling over the Victoria Falls is not. Thus in the case of turbulence the equation is simple but the practical effects defy analysis. Therefore on the vertical axis, our understanding of the equation for the speed at which a drop of water will fall is relatively simple and so the concept is low on the vertical axis. But because turbulence is extremely complex in terms of the phenomenon of a drop of water falling over the Victoria Falls, the concept of turbulence is way out along the horizontal axis towards the end.

On the other hand we have no real understanding of what quantum gravity is and what the basic equations are and so quantum gravity is very high on the vertical axis. If we did understand the basic equations, it seems that it ought to be quite simple in terms of the complexity of phenomena on the horizontal axis.

In the case of the law, the social sciences and economics, we do not understand the algebra. Similarly the complexity of phenomena are almost incomprehensible in their diversity and complex interrelationships. The fact is we do not really know the basic equations in law and, even if we did, the operation of the law in the real world is extremely difficult to assess scientifically and objectively.

This is not to say that the attempt should not be made and indeed it must be made if we are successfully to get the law to enhance our survival possibilities and at the same time to minimise legal risks.

One of the problems in the area of financial and corporate law is a relative scarcity of good international data on legal systems and an even greater scarcity of statistical and quantitative studies which cover a large number of jurisdictions, not just a few of the usual suspects, and which calibrate what is really happening at a detailed level.

One can produce many examples of complexity. One illustration which is particularly striking relates to the strong-arm banking resolution statute passed in the UK in 2009 which gave the regulators strong-arm powers over insolvent banks in order to rescue them. The powers given to the authorities were so wide that it was considered that certain fundamental features of English bankruptcy law should be ring-fenced and safeguarded or protected so as not to prejudice predictability in financial markets. One of these traits of English bankruptcy law is the availability of a set-off and netting. These are very substantial risk mitigants in enormous markets, such as the foreign exchange market (which is the largest market in the world by a long way, with flows of 30-40 times world GDP annually). The legislator therefore decided to protect set-off and netting from the impact of a bank resolution and did so in the terms set out in the Appendix at the end of this chapter.

If then you were a trader on a trading floor in a bank carrying out very large foreign exchange transactions, you would have to be told whether your particular transaction was protected by the safeguards in the statute. Typically, the trader has access to electronic synthesised data, eg a traffic light system. So a lawyer has to synthesise the data so that the trader can see whether that particular deal is net or gross within a few seconds. If the lawyer were to get it wrong, the bank could be faced by colossal losses if the counterparty should become bankrupt before the foreign exchange deal is settled. Even the most experienced experts would be challenged to work out what is and what is not within the scope of this safeguard and indeed, if you read it carefully, there are some red flags. Then multiply that by a few hundred jurisdictions.

Amounts involved

The amounts involved in financial law and transactions are colossal. For example, the flows of financial assets are a large multiple of trade flows and the turnover through payment systems and through foreign exchange markets is a many times multiple of world GDP. The world's biggest corporate bankruptcy was for over $500 billion – Lehmans in 2008, beating the previous record of WorldCom in July 2002. The world's biggest sovereign bankruptcy – Greece in 2012 – involved an exchange of more than $200 billion and involved much larger amounts of other debts so that the bankruptcy was in fact bigger than that of Lehmans. The previous biggest sovereign bankruptcy – Argentina in 2001 – involved debt of over $130 billion. Some syndicated credits have been for more than $30 billion, the same size of the IMF financial package for Brazil in 2002. The amounts involved in derivatives are enormous, many trillions, even if we take into account actual exposures and not the nominal amounts of principal involved.

If GDP does increase worldwide, then these figures will be multiplied.

The financialisation of the future

Economic historians trace economic history in terms of progress from a pastoral and agricultural economy, through to a manufacturing and industrial economy, through to a services economy. In the modern world in most developed economies, agriculture involves only around 2% of GDP, and manufacturing 25%. The rest is services, such as construction, insurance, banking and retail.

If it is true that world GDP will double or even triple in coming decades, then the world is faced with a financialisation of the future, ie a move from hard services and a "real" economy to an economy in which finance plays a major role.

The attitude which we should adopt to this can be illustrated by another allegory, again based on a famous painting. This is Botticelli's "**The Birth of Venus**" painted in 1486 and displayed here. It hangs in the Uffizi in Florence.

The birth of Venus

This is one of Botticelli's greatest paintings. He did not try to say too much in the picture and it therefore says a lot.

Like the raft of the Medusa, the main figure is also on the sea and on some sort of raft. In this case the raft is a seashell. Quite a miraculous and magic seashell actually, considering the quite substantial lady it has to carry through the waves. Botticelli was depicting magic, a beautiful illusion.

Botticelli's Venus is a symbol of the purity of some utopian past, a garden of Eden, a world of simple pleasures, a world of sweetness and light, long before the dull plod of mechanised agriculture, the smoke of industrial factories, long before the fantastic growth of intangible assets in the form of money and banks, companies and securities. This antique world is the world we yearn for.

One of the most remarkable features of the new financialised landscape is the fear of the future, the desire to go back.

For example, policymakers treat securitisations, derivatives and hedge funds as if they were some dangerous new speculation, over-engineered, designed to confuse and mislead, casino products, socially useless.

This reaction is a repeat echo of the ancient prejudices against interest, insurance and securities exchanges when those institutions first appeared centuries ago and led to laws against usury and gambling.

Securitisations are merely an extension of the concept of factoring or discounting of debts, a simple financing technique, much developed at the time of the Renaissance when merchants sold bills of exchange for the price of sold goods to the new bankers in order to raise money. It would be hard to imagine a simpler transaction than the sale of receivables to raise money. In modern securitisations, most of the assets themselves are simple, eg home loans. The capital structures are much simpler than that of many corporations – senior, junior, very junior. That is, 1, 2, 3.

Just as you can insure your car against a crash and your home against a fire, so you can protect the interest rates you pay, your currencies, your bonds against loss. These are derivatives. The concept is perfectly legitimate, simple and straightforward. Insurance of such items as ships, houses and liability has been a major feature of our societies for around four centuries. The transactions are considered useful. They build the chateau on the hill.

We cannot go back to some distant antique world where these things did not exist. They do exist. The old world is obsolete, out-of-date. To go back is to deny the future, to regress.

The idea that banks, for example, should return to narrow banking, ie that they should only take deposits and make loans and that they should not trade in financial instruments or set up funds or transact derivatives, is a return to the past.

It is quite true that all of these transactions involve legal risks and often legal risks on a grand scale. But the future has to be faced. In 1851 there were probably only three cities with more than a million people, namely, Paris, Beijing and London. Now there are easily 500 cities of more than a million people and some urban spreads are projected to rise to 50 million or even 100 million. Some aspects of cities are nice, others are pretty horrid. Just as we cannot order people to go back to the land and their ploughs (although China and Cambodia tried this in the 1960s and 1970s), so we cannot order them to stop producing, to stop generating wealth, to stop the increase in GDP, to banish banks, to do away with corporations.

There is another more profound aspect. The past depicted in the picture by Botticelli was a dream. It never existed. In fact, in the real past, before our centuries, everywhere in the world it was dirty, dark, diseased and dangerous. In the good old days our homes were squalid without running water or electric light. Mothers and children died in childbirth. Life expectancy was less than 50. That is what life is still like for many people. Money, finance, banks, corporations, and credit involving the sharing of savings are a major contributor towards enabling many people to escape the old gloomy life.

So if there is huge legal risk in the future, we should not retreat from it. We should combine the rational and the sensible and we should combine morality and efficiency, justice and utility and in that way aspire to the ideals of the lady with the flags and the lady in New York Harbour. We might then avoid the terrible raft in the Saharan sun. We might even perhaps achieve Botticelli's vision, the meaning of the allegory of his picture.

Appendix to Chapter 4

A simple puzzle

Please read the following and then answer the question at the end. You have ten minutes

The issue for consideration here is whether a bank which enters into a derivative or deposit or other contract with a counterparty will be able to net-out the contract as against other contracts with the same counterparty if the counterparty becomes subject to strong-arm insolvency proceedings. The counterparty is a bank incorporated in the UK.

The UK Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009 safeguards certain types of netting against the impact of the Banking Act 2009, notably transfers of part of the assets or liabilities of a bank.

For example, a counterparty who has a row of contracts with the insolvent bank expects to be able to terminate the contracts, calculate the losses and gains on the contracts and set-off all the losses and gains on all those contracts if the bank defaults so as to reduce these losses and gains by set off to a net amount. If some but not all of the contracts are transferred to, say, a bridge bank, then this ability to net losses and gains across all of the contracts might be prejudiced. This would typically be the case where the authorities transfer profitable contracts to a bridge bank, but leave behind loss-making contracts.

The Order applies only where there has been a partial property transfer, not a universal succession.

Thus the Order applies only:

- where a partial property transfer has been made by the Bank of England in accordance with section 11(2) or 12(2) of the Act;
- where:
  - (a) the Bank of England has made a property transfer instrument in accordance with section 11(2) or 12(2) of the Act (whether or not that instrument is a partial transfer); and
  - (b) a property transfer instrument under section 42, 43 or 44 of the Act has been made by the Bank which is a partial property transfer; and
- where:
  - (a) the Treasury have made a share transfer order in accordance with section 13(2) of the Act (including that section as applied by section 82 of the Act); and
  - (b) a property transfer instrument has been made by the Treasury under section 45 or 46 of the Act (including those sections as applied and modified by section 83 of the Act) which by virtue of section 45(5)(b) or 46(5)(b) of the Act is to be treated as a partial property transfer.

A property transfer instrument or order which purports to transfer all of the property, rights and liabilities of a banking institution shall be treated as having done so effectively, notwithstanding the possibility that any of the property, rights or liabilities are foreign property and may not have been effectively transferred by the property transfer instrument or order: reg 1(5).

A partial property transfer to which the Order applies "may not provide for the transfer of some, but not all, of the protected rights and liabilities between a particular person ("P") and a banking institution under a particular set-off arrangement, netting arrangement or title transfer financial collateral arrangement." Reg 3(1).

A partial property transfer to which the Order applies "may not include provision under the continuity powers which terminates or modifies the protected rights or liabilities between P and a banking institution." Reg 3(2). The continuity powers are broadly the powers of the authorities in s 64 of the Banking Act 2009 to order a transferring bank to provide services and facilities to a transferee bank, eg IT, and to order a modification or cancellation of contracts accordingly.

Rights and liabilities between P and a banking institution "are protected if they are rights and liabilities which either P or the banking institution is entitled to set-off or net under a set-off arrangement, netting arrangement or title transfer financial collateral arrangement which P has entered into with the banking institution so long as they are not excluded rights or excluded liabilities." Reg 3(3).

A transfer is total even though it may have failed to transfer foreign property. Reg 3(4).

In the regulation, "excluded rights" and "excluded liabilities" have the meanings given in reg 1 except that the reference to subordinated debt and the references to transferable securities in paragraph (f) of the definition of "excluded rights" shall be treated as if they were respectively a reference to subordinated debt or transferable securities issued by P or by the banking institution. Reg 3(6).

The definitions which apply are as follows (square-bracketed text is expansion or explanation):

"**Banking institution**" means (amongst other things):

- broadly a UK authorised deposit-taker incorporated in the UK;
- a bridge bank to which the authorities order a transfer;
- a building society; or
- a holding company.

"**Excluded rights**" are the rights which are excluded from the set-off and netting protections. The term means rights:

(a) which relate to a retail deposit made with a banking institution [mainly insured deposits];

(b) which relate to a retail liability owed to a banking institution [a liability owed by a retail depositor];

(c) which relate to a contract which was entered into by or on behalf of a banking institution otherwise than in the course of carrying on of an activity which relates to relevant financial instruments [as defined below] or an activity referred to in Annex I to the Banking Consolidation Directive [Directive 2006/48/EC of the European Parliament and of the Council relating to the taking up and pursuit of the business of credit institutions];

[The activities referred to in Annex I are:

"1. Acceptance of deposits and other repayable funds.

2. Lending, including inter alia: consumer credit, mortgage credit, factoring, with or without recourse, and financing of commercial transactions (including forfeiting).

3. Financial leasing.

4. Money transmission services.

5. Issuing and administering means of payment (eg credit cards, travellers' cheques and bankers' drafts).

6. Guarantees and commitments.

7. Trading for own account or for account of customers in:

(a) money market instruments (cheques, bills, certificates of deposit, etc.);

(b) foreign exchange;

(c) financial futures and options;

(d) exchange and interest-rate instruments; or

(e) transferable securities.

8. Participation in securities issues and the provision of services related to such issues.

9. Advice to undertakings on capital structure, industrial strategy and related questions and advice as well as services relating to mergers and the purchase of undertakings.

10. Money broking.

11. Portfolio management and advice.

12. Safekeeping and administration of securities.

13. Credit reference services.

14. Safe custody services."]

(d) which relate to a claim for damages, an award of damages or a claim under an indemnity which arose in connection with the carrying on by a banking institution of an activity which relates to relevant financial instruments or an activity referred to in Annex I to the Banking Consolidation Directive;

(e) which relate to subordinated debt; or

(f) which relate to transferable securities (other than transferable securities referred to or described in a set-off arrangement, netting arrangement or title transfer financial collateral arrangement between a banking institution and another person). The term "transferable securities" has the meaning given in the Markets in Financial Instruments Directive.

"**Excluded liabilities**" are interpreted accordingly.

"**Financial instrument**" means:

"(a) any instrument listed in Section C of Annex 1 to the Markets in Financial Instruments Directive [Directive 2004/39/EC of the European Parliament and of the Council on markets in financial instruments] read with Chapter VI of the Commission Regulation 1287/2006/EC;

[The instruments listed in section C are as follows (inserts into the actual language of the Annex are in internal square brackets):

(1) "Transferable securities. [These are securities which are negotiable on the capital market (except instruments of payment) such as corporate shares; bonds and other forms of securitised debt; depository receipts in the above two cases, and other securities giving a right to acquire or sell the above or giving rise to a cash settlement by reference to transferable securities, currencies, interest rates or yields, commodities or other indices or measures: see art 4(1) of the Directive.]

(2) Money-market instruments [such as treasury bills, certificates of deposit and commercial paper, but excluding instruments of payment: see art 4(1)].

(3) Units in collective investment undertakings.

(4) Options, futures, swaps, forward rate agreements and any other derivative contracts relating to securities currencies, interest rates or yields, or other derivative instruments, financial indices or financial measures which may be settled physically or in cash.

(5) Options, futures, swaps, forward rate agreements and any other derivative contracts relating to commodities that must be settled in cash or may be settled in cash at the option of one of the parties (otherwise than by reason of a default or other termination event).

(6) Options, futures, swap, and any other derivative contract dating to commodities that can be physically settled provided that they are traded on a regulated market and/or an MTF.

(7) Options, futures, swaps, forwards and any other derivative contracts relating to commodities, that can be physically settled not otherwise mentioned in C.6 and not being for commercial purposes, which have the characteristics of other derivative financial instruments having regard to whether, inter alia, they are cleared and settled through recognised clearing houses or are subject to regular margin calls.

(8) Derivative instruments for the transfer of credit risk.

(9) Financial contracts for differences.

(10) Options, futures, swaps, forward rate agreements, and any other derivative contracts relating to climatic variables, freight rates, emission allowances or inflation rates or other official economic statistics that must be settled in cash or may be settled in cash at the option of one of the parties (otherwise than by reason of a default or other termination event), as well as any other derivative contracts relating to assets, rights, obligations, indices and measures not otherwise mentioned in this Section, which have the characteristics of other derivative financial

instruments, having regard to whether, inter alia, they are traded on a regulated market or an MTF, are cleared and settled through recognising clearing houses or are subject to regular margin calls. [Council Regulation No 1287/2006 (Mifid 3) adds in art 39 a number of other non-financial derivatives, for example, derivative contracts relating to telecommunications bandwidth, commodity storage capacity and transportation, permits and rights relating to energy, geological, environmental or other physical variables, and a catch-all of "any other asset or right of fungible nature, other than a right to receive a service, that is capable of being transferred" and "an index or measure related to the price or value of, or volume of transaction in my asset, right, service or obligation".]

According to Mifid 3 art 38 a commodity derivative within Mifid Annex I(C) (7) will be considered as having the characteristics of other derivative financial instruments and not being for commercial purposes if it satisfies the following conditions:

"(a) it meets one of the following sets of criteria:

(i) it is traded on the third country trading facility that performs a similar function to a regulated market or an MTF,

(ii) it is expressly stated to be traded on, or is subject to the rules of, a regulated market, an MTF or such third country trading facility;

(iii) it is expressly stated to be equivalent to a contract traded on the regulated market, MTF or such third country trading facility;

(b) it is cleared by clearing house or other entity carrying out the same functions as a central counterparty, or there are arrangements for the payment or provision of margin in relation to the contract;

(c) it is standardised so that, in particular, the price, the lot, the delivery date or other terms are determined principally by reference to regularly published prices, standard lots or standard delivery dates."

As to the special non-financial derivatives in Annex 1(C)(10) of Mifid 1, these contracts will be included if they have the characteristics of other derivative financial instruments as specified in that section. Mifid 3 expands the test by stating that these derivative contracts will be considered to have the characteristics of other derivative financial instruments if one of the following conditions is satisfied:

"(a) that contract is settled in cash or may be settled in cash at the option of one or more of the parties, otherwise than by reason of a default or other termination event;

(b) that contract is traded on a regulated market or an MTF;

(c) the conditions laid out in [art 38(1) above] are satisfied in relation to that contract": see Mifid 3 art 38(3). There is a minor exception for energy transmission grids and the like in art 38(4).

[According to Mifid 3 recital 26 the concept of commodity "should not include services or other items that are not goods such as currencies or rights in real estate, or that are entirely intangible".]

(a) any option, future, swap, forward, contract for differences or other derivative contract not falling within paragraph (a); and

(b) any combination of any of the foregoing."

"**Relevant financial instrument**" means:

"(a) a financial instrument;

(b) a deposit;

(c) a loan;

(d) an instrument which falls within article 77 of the Regulated Activities Order (disregarding the exclusions in article 77(2)(b) to (d)) [Article 77 covers mainly such things as debentures, bonds, certificates of deposit and any other instrument creating or acknowledging indebtedness]; or

(e) any contract for the sale, purchase or delivery of:

(i) transferable securities;

(ii) the currency of the United Kingdom or any other country, territory or monetary union;

(iii) palladium, platinum, gold, silver or any other precious metal; or

(iv) any other commodity."

"**Title transfer financial collateral arrangements**" has the meaning given by regulation 3 of the Financial Collateral Arrangements (No 2) Regulations 2003. This regulation 3 defines "title transfer financial collateral arrangement" as "an agreement or arrangement, including a repurchase agreement, evidenced in writing, where:

(a) the purpose of the agreement or arrangement is to secure or otherwise cover the relevant financial obligations owed to the collateral-taker;

(b) the collateral-provider transfers legal and beneficial ownership in *financial collateral* to a collateral-taker on terms that when the *relevant financial obligations* are discharged the collateral-taker must transfer legal and beneficial ownership of *equivalent financial collateral* to the collateral-provider; and

(c) the collateral-provider and the collateral-taker are both *non-natural persons*." [Italicised terms are defined in the 2003 Regulations.]

"**Transferable Securities**" has the meaning given by Article 4(18) of the Markets in Financial Instruments Directive.

This Directive defines transferable securities to mean broadly those classes of securities which are negotiable on the capital market (with the exception of instruments of payment), such as corporate shares; bonds and other forms of securitised debt; depository receipts in the above two cases and other securities given the right to acquire or sell such transferable securities or giving rise to a cash settlement determined by reference to transferable securities, currencies, interest rates, commodities or other indices or measures.

References in the Order to "**netting arrangements**" include:

"(a) arrangements which provide for netting (within the meaning given by regulation 2(1) of the Financial Markets and Insolvency (Settlement Finality) Regulations 1999); and

(b) arrangements which include close-out netting provisions (within the meaning given by regulation 3 of the Financial Collateral Arrangements (No 2) Regulations 2003)."

Regulation 2(1) of the 1999 Regulations defines "netting" as follows: "the conversion into one net claim or obligation of different claims or obligations between *participants* resulting from the issue and receipt of *transfer orders* between them, whether on a bilateral or multilateral basis and whether through the interposition of a *clearing house*, *central counterparty* or *settlement agent* or otherwise.

The above regulation 3 of the 2003 Regulations defines "close-out netting provision" as "a term of a *financial collateral arrangement*, or of an arrangement of which a *financial collateral arrangement* forms part, or any legislative provision under which on the occurrence of an *enforcement event*, whether through the operation of netting or set-off or otherwise:

(a) the obligations of the parties are accelerated to become immediately due and expressed as an obligation to pay an amount representing the original obligation's estimated current value or replacement cost, or are terminated and replaced by an obligation to pay such an amount; or

(b) an account is taken of what is due from each party to the other in respect of such obligations and net sum equal to the balance of the account is payable by the party from whom the larger amount is due to the other party."

[Italicised terms are defined in the relevant 1999 and 2003 Regulations.]

Question: Prepare a note to traders at a bank whether netting is available in Britain against insolvent counterparty banks. Not more than five lines.

PS: If the trader gets this wrong, the amounts of the bank at risk could run into billions. No pressure!

Chapter 5

Harmonisation and commoditisation

There has been a technological revolution. Does the technological revolution mean that lawyers will wither away, that law will just become a matter of a finger on the screen and out will come a suitable commoditised document not needing any negotiation, a crafted commentary on the main points and all the law in all jurisdictions relevant to the transaction in hand? Will litigation be displaced by electronic mediation services quickly resolving every problem?

If so, there would be no need for judges or tribunals. Or university law faculties. Or in-house legal departments or law firms. Law would become just a commodity, like a sandwich, whatever the transaction, whatever the problem, whatever the stakes.

There is no question that the technological revolution is and will continue to be transformational. But there has also been a legal revolution, also transformational. In addition there is an economic revolution in progress in the form of the increase in GDP, mainly in emerging countries. The interplay between these three revolutions is key.

Harmonisation of corporate and financial law

One would expect that as the law becomes larger and more complicated, there would be an attempt to harmonise the law across so many jurisdictions so as to reduce not just costs, but also legal risk. The evidence so far shows that this is not happening to a sufficient degree in crucial areas of the law. Rather there is a splintering or fragmentation of the law, like a stone hitting a car windscreen.

This is partly because the law is driven by national legislatures and the desire to protect the local society. Tribalism is fine for football, but not for bigger matters.

The advantages of harmonisation include the avoidance of legal ambush and surprise leading to a potentially expensive legal risk, the reduction of investigation and transaction costs, and efficiency. Many differences between legal systems are historical, not cultural, ie they do not reflect differences in the current and national mood or the state of the industrialisation.

Disadvantages of harmonisation include: competition as a spur of our legal systems, leading hopefully to a race to the top to the best models, eg a liberal system without risk; the jurisdiction has local democratic controls and accountability; there is more freedom to adapt the law and the process is nimbler; and the legal system can reflect the structure of the economy, eg depth of banking system size and ingenuity of the

financial sector, the role of business corporations and the size of equity markets. A jurisdiction may have resources which are far too meagre to develop the legal infrastructure and may have other priorities, eg staying alive.

Whether financial and corporate law needs to reflect cultural differences is highly debatable. Many of these national or ethnic differences seem to be a means of creating identity and are not based on factual differences between human needs. The current degree of fissuring is considered unjustifiable.

The Delaware factor

If market participants are free to choose their legal system, so long as this choice is not in conflict with fundamental morality, then this would be a major risk mitigant. If they can choose, then they can choose a legal system which is the most liberal and which has the least risk.

In fact this choice of a particular regime is particularly notable in a number of areas. We call this the "Delaware factor" which means that participants prefer the simplicity and familiarity of a single regime which takes them and the law seriously. For example, both English and New York law have a dominant position as the governing law of major contracts such as syndicated loan agreements, capital markets bond issues and derivative contracts. These two legal systems have a near monopoly and are effectively like a public utility for the international community, even though they differ somewhat in their detailed attitudes.

As to corporate law, it is thought that about 70% of U.S. listed corporations are formed in Delaware. The reasons for this are that Delaware took corporate law seriously and made an effort to protect management and have an efficient corporate law system. Another example is the U.S. Depository Trust Corporation which is the settlement system for virtually all listed equity shares in the U.S., amongst other things. Similarly the bank payment messaging system, SWIFT based in Belgium, is used by virtually all international banks for their payment messages.

The Uniform Customs and Practices for Documentary Credits has also virtually a worldwide monopoly in the field of trade letters of credit.

All of these are instances of monopolies chosen by the markets concerned because of the efficiency and fairness of the service. Markets have the freedom to vote with their feet but are not inclined to do so, so long as the service continues to perform.

However, in many critical areas of law which lead to legal risk, this freedom to choose is not available and instead national law fetters and manacles markets to the national view of what the law should be. This is generally true of the major legal risk fields of (1) bankruptcy and (2) regulation. In both fields the rules are mandatory and, apart from minor exceptions, you cannot choose your legal regime in the same way that you

can choose the governing law of a contract. The regimes override governing law. You can only escape by not doing business in the adverse jurisdiction at all, and even then you can get caught by extraterritorial laws.

Methods of harmonisation

The methods of harmonisation include:

- Peer pressure and the desire to benefit from markets.
- Negotiated conventions – these are difficult to change and sometimes tend to reflect the lowest common position.
- Model laws, eg by Uncitral, Unidroit, EBRD and others. These enhance the pooling of international expertise and consensus; they are not mandatory.
- Soft law, eg Basel capital adequacy rules for banks. Some of this is standard-setting by developing consensus principles. Standard-setting allows a degree of local freedom.

Broad survey of harmonisation

It is not the case that similar circumstances lead to similar laws.

For example as we will see later, there is a remarkable lack of convergence or harmonisation in such matters as bankruptcy set-off and netting, direct liabilities for deepening an insolvency, the availability of the trust and custodianship and many other significant areas affecting banks and corporations.

These splits resulted from the historical triple polarisation of the law in and before the 19th century. It also resulted from increasing splits flowing from patchy reactions to the demands of credit economies and the impulse of debtor and creditor politics, ie whether the law should protect debtors or creditors. In addition, the diversity is driven by national law-making sovereignty. There is internal tiering, as different political views come into conflict, eg as to whether to protect sophisticated investors or consumers, but leaving a broken middle.

Although at great distance there may appear to be some convergence, such as the adoption of corporate rescue statutes in many countries, closer up there is much fissuring and splintering of legal systems into blocs and enclaves. We have already mentioned the division of security interests in English law into eight tiers and the number of insolvency regimes in England, amounting to around 25.

In the field of financial regulation there is some consensus on, for example, the regulation of offering circulars, bank capital adequacy standards, insider dealing and money laundering but there are still major

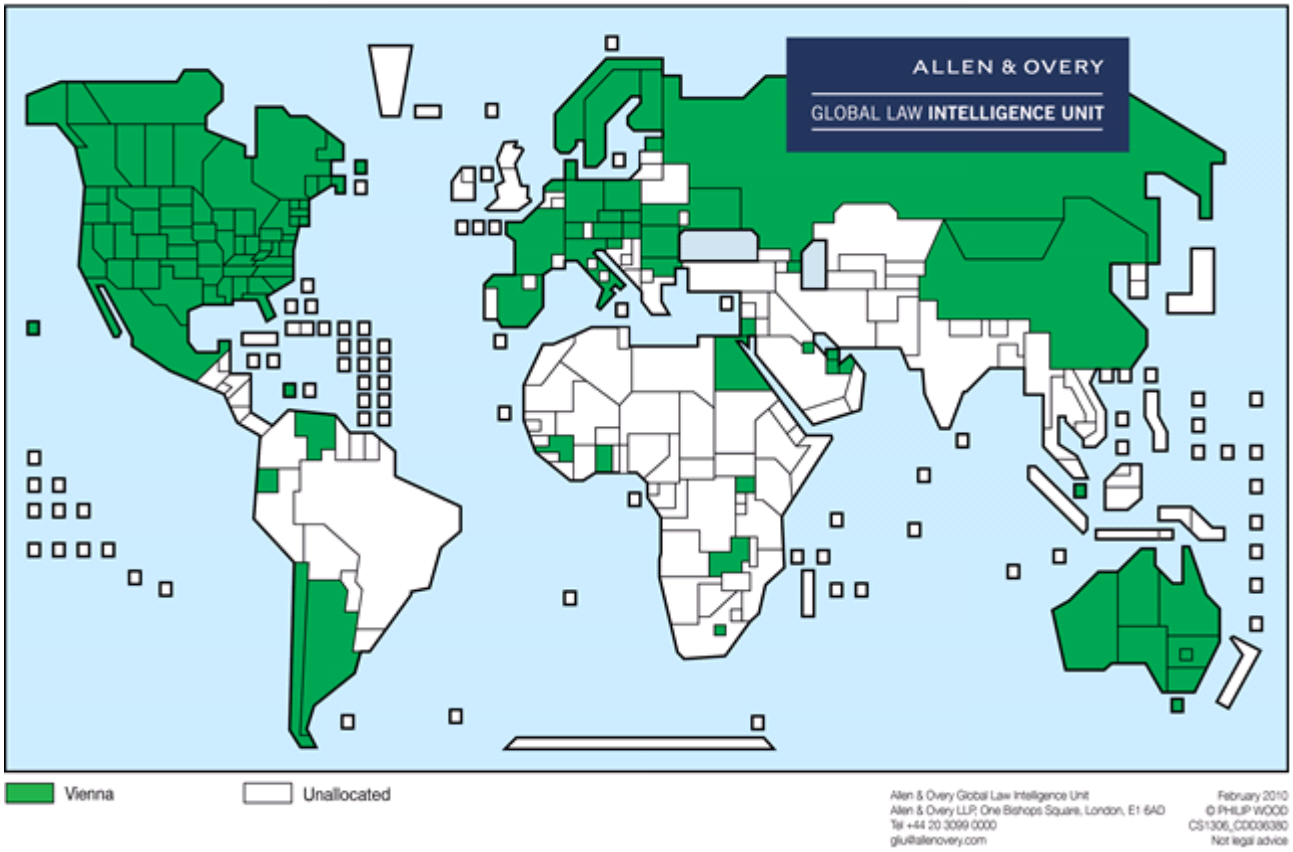
differences and national protectionism in this field. The degree of ferocity of punishment for violations is very different.

Accounting standards are rapidly converging so as to achieve some degree of comparability. But convergence in corporate law seems more questionable.

Contract law is not considered toxic worldwide since here there is much international agreement on the fundamental propositions of a contract and since there is substantial freedom of contract outside the consumer arena. Nevertheless there are significant difficulties. But it is not contract law which poses the main risks, it is property, regulation and bankruptcy.

Sometimes conventions can produce a degree of harmonisation. For example the Vienna Sales Convention 1980 established a uniform set of legal principles governing the formation of contracts for the international sale of goods, the obligations of the buyer and seller, remedies for breach of contract and other aspects of the contract. The accompanying map "**Vienna Convention on International Sale of Goods 1988**" shows how widely the Vienna Convention has been accepted.

Vienna Convention on International Sale of Goods 1988

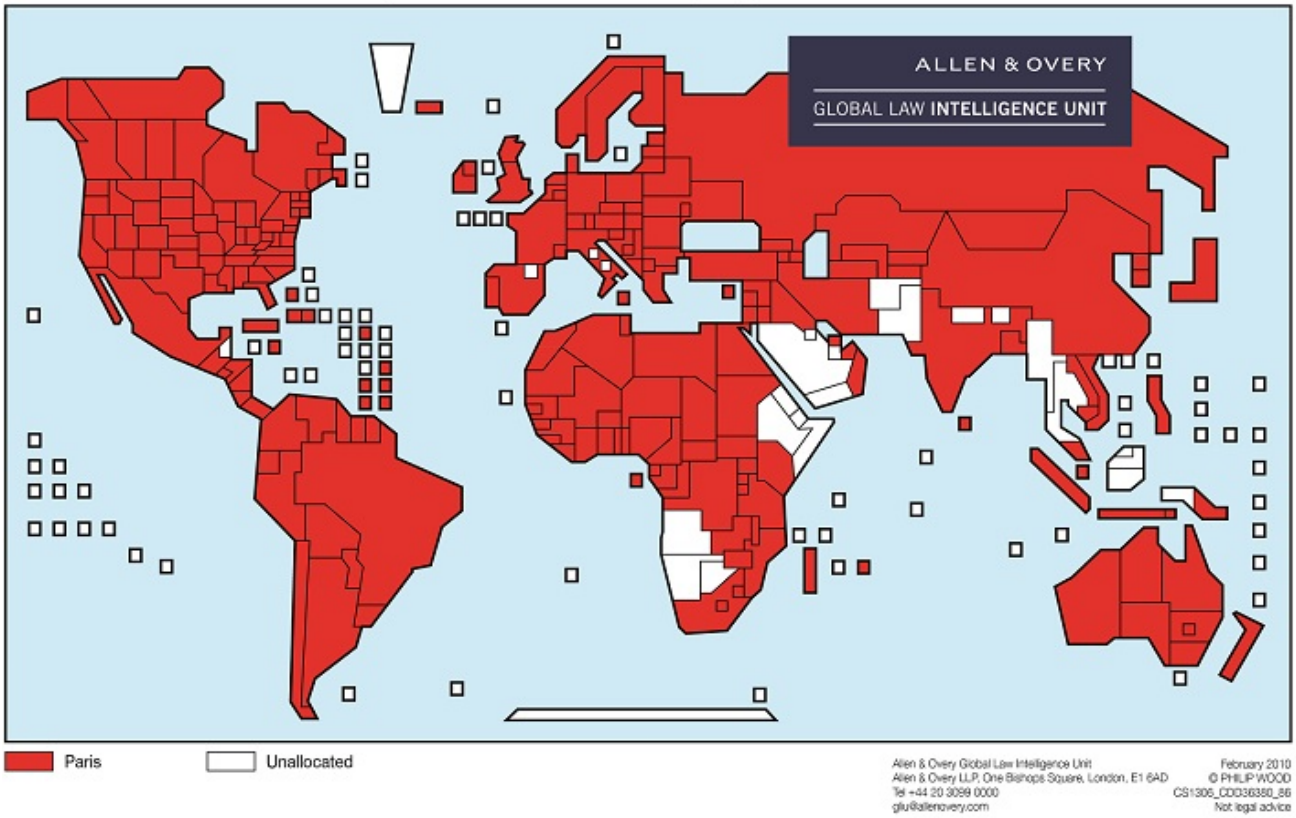


Nevertheless the Convention is not by any means comprehensive in its terms. In particular the Convention does not deal with the transfer of the title to the goods which is probably one of the most important aspects of

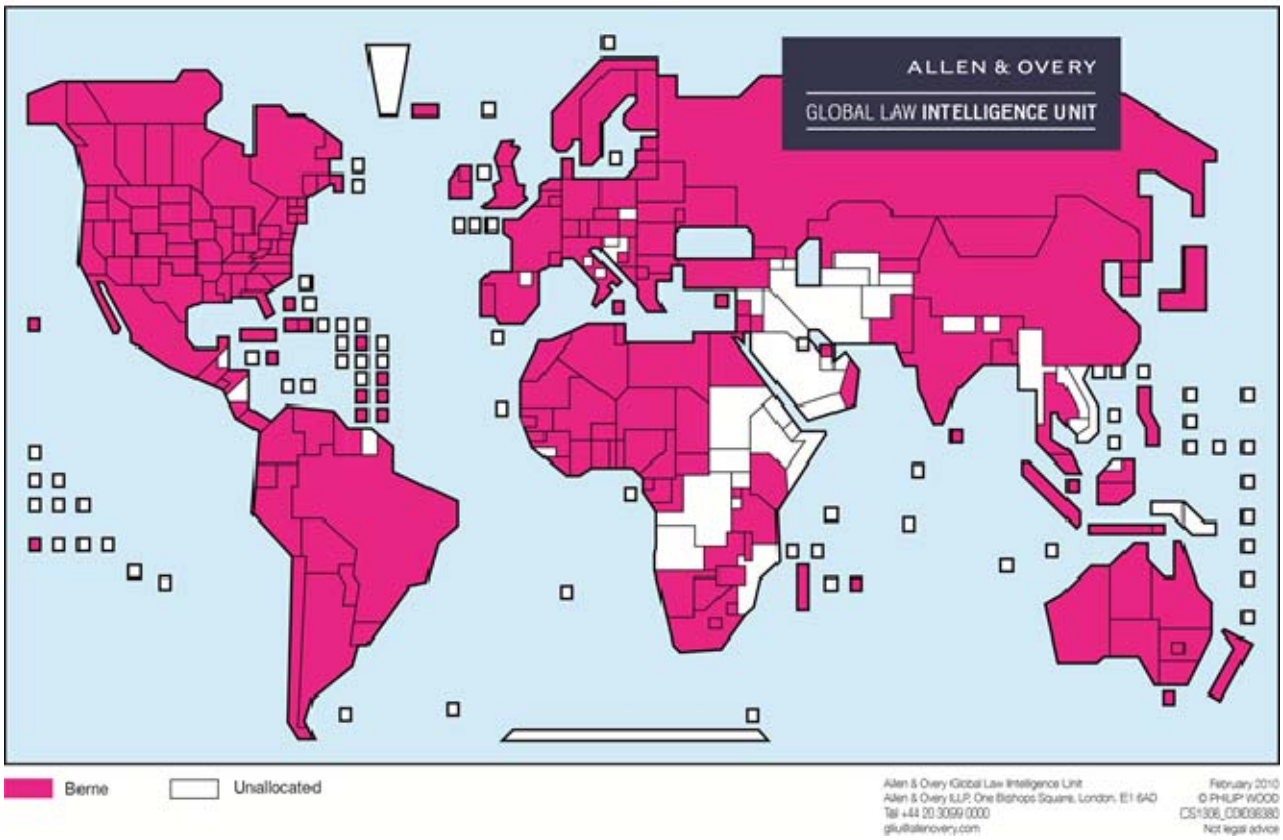
sales. The timing of the transfer property is crucial on insolvency. As is usual in the case of insolvencies, the states could not agree so they just left it out.

The following series of maps show the degree of international agreements in relation to intellectual property – **Paris 1883**, **Berne 1886** and **Geneva 1952**.

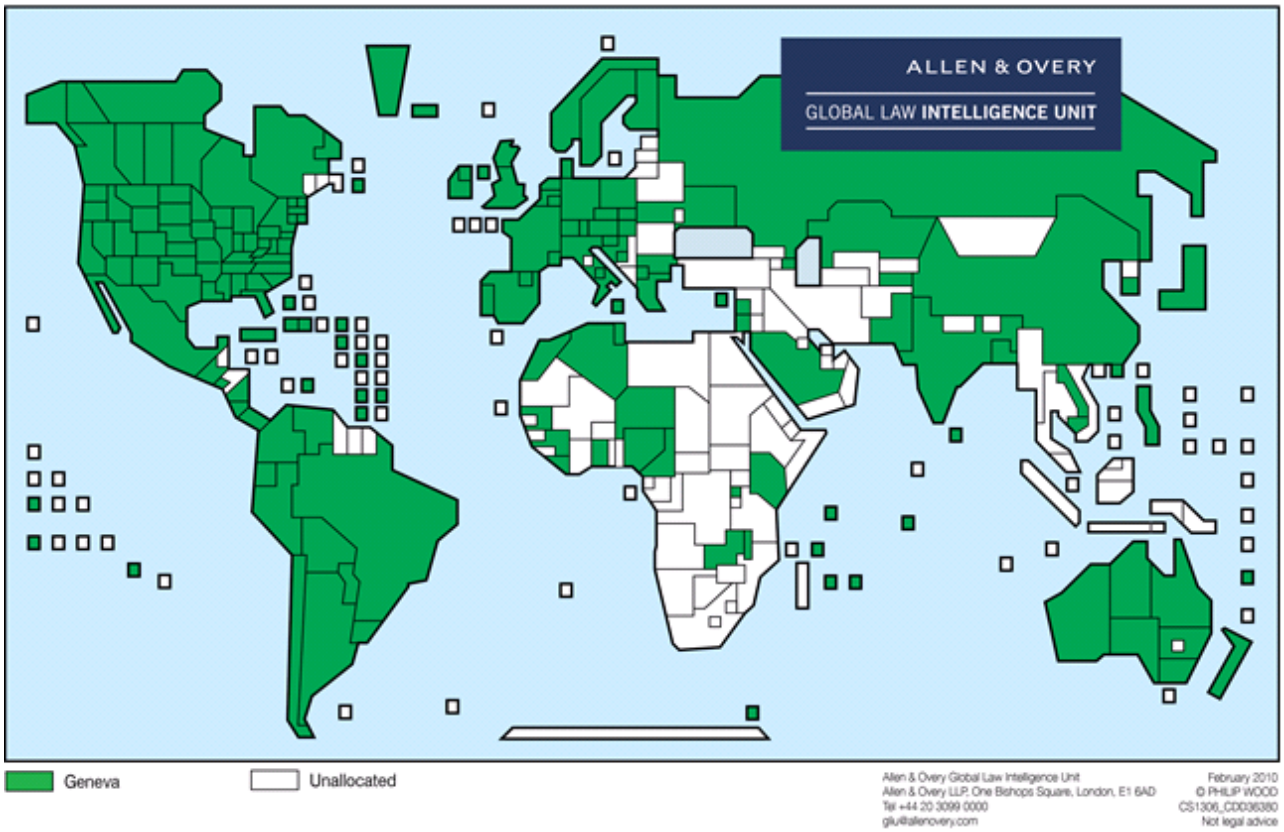
Paris Industrial Property Convention 1883



Berne Copyright Convention 1886



Geneva Universal Copyright Convention 1952



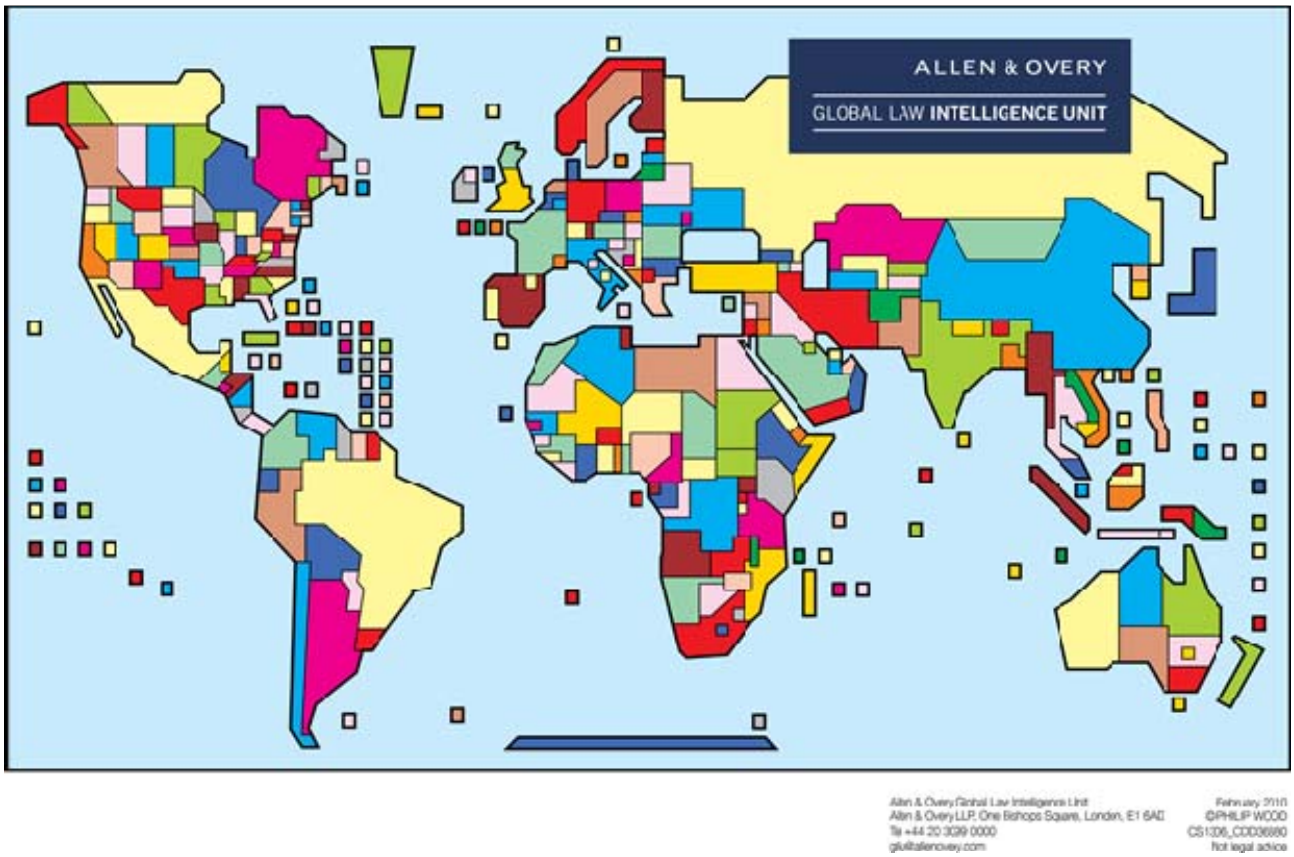
If you look at the detail, you find that these conventions do not in the main harmonise the law. They usually provide for reciprocity of national treatment, a priority system for applications and sometimes minimum standards.

Conclusion on harmonisation

Prophecy is difficult. Two maps show two possible outcomes for harmonisation of corporate and financial law. See the map "**Global jurisdictions in 2030 – a prophecy**" and the conflicting map "**Global jurisdictions in 2030 – a second prophecy**".

Global jurisdictions in 2030 – a prophecy

Global jurisdictions in 2030 – a second prophecy



The reality is that some of the basic issues identified at least by the 19th century and giving rise to legal risk have not yet been resolved. The issues are difficult, but not all that difficult. The law is our servant and not our master.

Commoditisation of documents

An intriguing question is whether, if the law is not harmonising, documents will be reduced to standard forms which no longer require lawyers.

Everything points towards the need for as much standardisation as possible in order to reduce costs, reduce risks and to augment transactions, especially those which were beneficial to our societies.

Banks and corporates need to be able to map exactly what is in all of their legal documents – for the purposes of calculating exposures, for tax, for accounting, for transfers of a portfolio of assets, and just simply to know what is going on. This too points to standardisation.

A large number of contracts have been standardised, notably those with consumers. Large banks and corporates have millions of customers and it would be quite impossible for them to do business without maximum standardisation of this documentation.

At the big ticket wholesale level, one would have thought that syndicated bank credits, international bond issues, and sale and purchase agreements for companies would be commoditised, since, after all, they seem to say roughly the same thing, repetitively year after year.

There has been some standardisation of wholesale documents, such as the epic syndicated bank credits developed by the Loan Market Association and its affiliated organisations elsewhere, the great ISDA master agreements and accompanying volumes of definitions, the Global Repurchase Master Agreement, and other financial standards. All of these and others show what can be done and what needs to be done.

What is so surprising is that the degree of standardisation is much less than one would have expected and certainly much less than what is possible. The reasons seem to include the following:

- Very large amounts are typically involved in significant international transactions and the legal costs are a tiny fraction of the overall amounts and hence a tiny insurance premium.

- Many deals are in fact complicated and the adverse consequences of error high. An international commentary on, say, the main issues in all jurisdictions of a leveraged takeover involving 100 jurisdictions, even if available on the internet, would run to a few thousand pages, which would need to be evaluated.

- Although the documents look similar, the legal environment around them impacting on their terms is horrific by reason of the legal revolution and otherwise massive and uncontrollable growth of law. We predict that legal risks could increase.

- In some areas, such as derivatives, the standardisation of documents, especially via ISDA master agreements and booklets of definitions, can hardly keep up with the practice. You have to be an expert to understand the standardisation.

- Many parties, such as issuers of debt or borrowers from banks, want documents which are their own and tailored to their needs. They tenaciously cling to the familiar document they negotiated last time.

- Documents widely used by a bank or large corporate may have become inextricably linked with numerous teams across its business (legal, credit, operations, tax, accounting, collateral management, treasury, etc.). It is a major task, in terms of updating internal systems and training, to change templates or adopt a market template even if to do so would be better for the business. Sometimes the tail is wagging the dog.

- Markets are very competitive so that businesses offer documents which they think are more marketable than those of competitors.

- It is often hard to persuade all the firms in a market to agree on what the standard document should say. For example, the standard syndicated credits of the Loan Market Association do not standardise key clauses.

- The idea that documents do not matter and that it is the relationship and trust which count has faded in international transactions. This may be a feature of international suspicions and hostilities, however irrational.

- People in different countries have different views about the fundamentals of documents, eg short or long, general or particular, a framework or a detailed specification. The entry of parties from a large number of emerging countries could exacerbate the conflict of cultural approaches.

- The legal revolution has exacerbated insecurities and led to a flight to safety.

- The case law and circumstances can give rise to some very unexpected results which overturn accepted views which in turn creates instability and unpredictability. A recent example was the litigation in 2012 and 2013 in the New York courts between a hedge fund and Argentina about the meaning and effect of the pari passu clause which appears in most bonds and syndicated bank loan agreements and which until then had been considered harmless.

- Legal systems continue to be fissiparous and schismatic.

- Aggressive litigation strategies and the long-arm exorbitant jurisdiction of most courts, plus extraterritorial laws, plus pugnacious enforcement by regulatory authorities, make transactors even more nervous.

Our predictions as to future GDP and the growth of law indicate that the above factors could be intensified.

Syndicated bank credits as an illustration

We may take the syndicated bank credit as an illustration. There are certainly a great many differences which make standardisation hard. The circumstances of the borrowers differ: thus the rating agencies have about 20 notches from AAA to default, with the result that key terms, such as covenants and events of default, would be very different over the range.

The businesses differ in terms of business risk and the character of the financial ratios needed to monitor financial condition. For example, the credit circumstances that impact on the documentation will vary according to whether the borrower is a water company or a pharmaceutical company or a computer company or a bank or a sovereign state. The borrowers may be located in emerging countries or developed countries which in turn will impact on key terms, including governing law and forum or arbitration.

The forms of finance differ, for example, bilateral or syndicated, secured or unsecured, plain vanilla or project finance, trade finance, aircraft or ships, real property or leveraged acquisition finance.

The culture of banks differs, eg whether they favour arm's length formality and detailed prescription or short documents. They have diverse attitudes to the tolerance of risk.

Even things, even boiler-plate which one had thought had been settled long ago, comes up for renewed collision with unexpected case law.

Multiply these and other variables and you get a fantastic number. The arithmetic is similar to that of one grain of wheat on the first square of the chess board, two on the second, four on the third and so on, until the 64th square when the grains of wheat would fill the entire universe – trillions and trillions. On this basis, you would have variants of the syndicated credits from here to the moon and back.

Experience shows that techniques of generating documents electronically can cope with a stupendous number of variables. Law firms, including ours, have invested huge sums in this. The approach is similar to chemistry. You identify the most elementary atoms and then combine them in as many different ways as you want to create infinite materials, infinite patterns. Three colours combine to create all the chromatic magic of the visible world. So these simple atoms or simple vibrating spectra are replaced by words in order to produce, well, everything.

And yet the universal take-up of this type of approach seems to be slow. The reality is that, outside plain vanilla bilateral term loan agreements used by banks for millions of customers, even the first electronic draft of a large syndicated credit, which greatly reduces the time and costs, still leaves a large number of issues which the parties want to negotiate. Economies go up and down and so documents are volatile too, blowing in the wind, this way and that. The complexity of the circumstances, when combined with the aspirations of the parties and their sense of particularity seems to defy the simplicity of automation. In addition, the other factors outlined above seem to inhibit the process. What seems to be happening is that the real world is spinning along way ahead of technology.

Delivery of legal data

Transactions involve documents, commentaries on the documents to facilitate negotiations, and legal data. Documents, doctrine, data. Litigation involves other procedures.

Technology can deliver very large quantities of data, synthesise it, organise it and render it searchable. Currently the extent of the provision of international legal data is a tiny proportion of what it could be, even on a subscription basis. The amount of international legal data available free or at low cost on the internet in the subjects I am interested in is deficient. Nevertheless, it is clear what can be done and that the

improvement in the universal accessibility of legal data could be enormous, far in excess of what it is at the moment.

It seems likely that lawyers will be even more necessary to interpret and explain this avalanche of data. It is difficult nowadays even for experts to understand their own little sliver of law, let alone read and understand all the rest, let alone be able to put it together internationally.

Many legal problems require an ability to make judgements about the future, judgements which are highly subjective. So the skills needed will be difficult and include a deeper understanding of legal concepts and an ability to see patterns and to synthesise.

It is difficult to see how banks of computers could tell us in 2014 what the rates of exchange between all of the world's currencies would be on, say, 13 February 2019 at 11:47am in London which might in turn result in a demand for collateral. It is difficult to believe that even the most massive artificial intelligence would be able to tell us whether there will be a small or big or insignificant or catastrophic financial crisis before 11:47am on that day or within the ten years after that, a crisis that could have cataclysmic effects on transactions. It is difficult to see that a machine could tell us what a judge would decide in the future on the meaning of a particular clause in the circumstances of a specific case. This kind of prediction involves subjective judgement and the weighing of probabilities where it is unlikely that people will believe a machine's prediction rather than their own. But it is an evaluation of future risks that is at the heart of most wholesale transactions.

If one takes any ten-year slice of history for the past century, it is easy to see how expectations as at the beginning of the decade were completely unanticipated, as events unfolded over these short periods of ten years – the life of many transactions.

Conclusion on commoditisation

If the predictions are right that the growth of GDP could lead to more crises and instability over the medium term of 15 to 20 years and lead to the intensification of law and an increase in legal conflicts, then the need to standardise documents to resolve disputes efficiently, and to deliver manageable legal data will become even more urgent and should be pursued relentlessly. Because of the potential intensification of risks and complexity, our prediction is that major transactions will not become commoditised so that lawyers become unnecessary, but on the contrary that lawyers of exceptional expertise and international understanding will be in high demand and will play an increasingly important role in the future.

In addition, lawyers will need to combine these traditional skills with the ability to interpret legal data, identify patterns and draw conclusions without the need always to check every underlying agreement.

At present, the technology, in relation to what it could do, seems backward and conservative.

Chapter 6
Managing and mitigating legal risks

Identify, assess, measure, mitigate – so simple?

The typical methodology for risk management involves four steps:

- **Identify** the risk, specify its characteristics and describe it clearly
- **Assess** the probability or likelihood of the risk happening, based on experience and collected data as far as possible
- **Measure** the impact of the risk, ie whether the consequences of the risk would be catastrophic or merely humdrum and routine, whether the loss would engulf the company or merely be a minor irritant
- **Mitigate** or manage the risk, that is to say, take steps to reduce the likelihood and impact of the risk so far as possible, but if it is not possible, then maintain adequate reserves against loss.

For many people, particularly those whose only real experience is economic modelling or statistical analysis, known in the vernacular as 'quants', all this is a very simple little mathematical process. The risks are obvious, the things you read about in the newspapers, so you just list them on a single sheet of paper, ten or perhaps a dozen of the main ones; well, maybe 20 if one is being pedantic and overcautious, like most lawyers.

You then put a figure on their likelihood - somewhere between one to ten or even one to five, based on probabilities which are well known to everyone and, if not, can be obtained from a quick Google. You then put a figure on the likely losses - again from one to ten or from one to five if you are really streamlined - another very simple process because the world is governed by clear causes and effects, just as an algebraic equation always leads to a numerical solution. You can calculate precisely what the flicker of a butterfly's wing in a Brazilian forest does to exchange rate policy in China. Then you put in hand all the necessary processes, procedures, systems and controls for the risk to vanish.

In the unlikely event it does not vanish, then mathematics will sort the problem. Do a scatter plot and a regression analysis on the data, work out the standard deviation and the correlation coefficients, work from a null hypothesis, and eliminate type I and type II errors. Multiply the whole thing by $(x/n^p)^2$, add a dash of the beta factor, mix and stir, and then serve up the risk factor to a 99% confidence level.

In the first place the identification of the risks is not feasible for international businesses. There are millions of risks. The prodigious multitude of potential legal risks applicable to a particular business is vast.

If a company sends out its prospectus around the world offering its securities for sale, it has to be sure that it is permitted to send the prospectus to residents of each country in the world without the necessity of complying with local prospectus requirements. This routine transaction, which takes place every day, so defies analysis that the issuer has to fall back to stating in the prospectus that the prospectus is not deemed to be received by anyone where it would be unlawful for that person to receive it. In other words, the intricate web of the international regulation of prospectuses is so impenetrable that no one can reasonably state what the rules are each time and ensure that they are complied with. The issuer and the underwriters just give up.

If you do send a prospectus into a country where the receipt of the prospectus is a violation of the prospectus rules, then you are exposed to criminal sanctions.

Likewise, the question of whether the dealer in derivatives or securities or foreign exchange on a trading desk in London can net out exposures with counterparties around the world would require a reference to a vast body of legal opinions commissioned by the International Swaps and Dealers Association Inc. or those producing opinions in relation to the Global Master Repurchase Agreements, together running to many thousands of pages of extremely complex text, understood only by experts in the field. Notwithstanding the prodigious efforts of those involved, it is hard to simplify. If you are wrong on netting, then your exposure is gross and not net, and this could result in potentially catastrophic losses if the counterparty should become bankrupt.

If you wanted to know whether the taking out of a contract for differences in relation to the shares of a listed company in a particular jurisdiction requires a disclosure to the stock exchange and the issuer, this can require a quite fantastic immersion in a subscription service explaining each jurisdiction's rules about shareholding disclosures (an affiliate of my firm runs such a service). It is commonly a criminal offence not to disclose holdings of between 3% and 5%. Is a bond convertible into shares a holding? Who discloses if there is a repo of shares or stock lending or a pledge? Every jurisdiction has its own views, which can be quite arbitrary, so that the application of common sense or reason is fruitless. Like a train timetable, you have to know that the train leaves at 7:41, not 7:42. If you enquired what deep moral policy requires this disclosure which necessitates such vast investigative expense by all firms that invest in shares, you will be told that corporate directors want to know if anybody is building up a stake.

The second reason that the simplistic approach of the quants is not justified is that the assessment and measurement of risk is a highly qualitative process. One reason for this is the huge variety of circumstances, the large number of variables and the general noise.

For example, you may be advised that security interests in a particular jurisdiction are weak because it is not possible for the security agreement to catch future assets, because unsecured preferred creditors, such as

employees, taxes and post-bankruptcy loans rank ahead of the security and because the security has to be enforced through the courts as opposed to a private sale. Notwithstanding these defects, the weak security interest may not be a deal-stopper in the case of a security granted by a single purpose project company since the assets are specific and existing, and the priority creditors are limited because, for example there are very few employees and because the lenders are controlling creditors on an enforcement who would not normally wish to sell but rather to manage the default. The risk assessment would be completely different in relation to security interests granted to a central counterparty in a derivatives or securities market where absolute predictability and speed are crucial. The situation would again be different if the debtor were a small business with a single house bank or if the security was over goods to support a letter of credit trade finance. Accordingly in evaluating security interests, the assessment is a much more judgemental process than simply enquiring whether security law is strong or weak.

How would you quantify the risks involved in omitting the negative pledge in an unsecured bank loan agreement? This clause prohibits the borrower from granting security over its assets to a third party so as to subordinate your loans. How would you quantify the risks involved in agreeing a high threshold for a cross-default in an ISDA master agreement? A cross-default makes it an event of default if the counterparty fails to pay other comparable debt or it is accelerated – a leading anticipatory event of default. These decisions require qualitative judgement which turns minutely on the particular circumstances and which are not amenable to a simple metric specified in advance in a table.

It has often been said that the models of the quants are too simplistic to reflect the complexity and intricacy of the real world, that they promise prophecies and give reassurance in a crisp matrix when the real world is fuzzy. So their truth is a caricature. Nevertheless synthesis and distillation are extremely important in the measurement of legal risks and it is right to aim at keeping it short and to the point. It is not wrong to be reductionist so long as we know what we are doing.

Operational risk for banks under Basel II

It is worth noting how bank regulators set capital adequacy standards in the Basel Capital Accord of 2004 – 2005, commonly known as Basel II, in relation to what is called operational risk, which includes legal risk.

Basel II was a set of standards establishing minimum capital requirements for internationally active banks. The initial basic proposition was that banks must have share capital and capital similar to equity capital of at least 8% of their exposures, for example a loan. Thus banks can lose 8% of their loans before depositors and other creditors lose anything – the first loss falls on the shareholder. The actual amount of capital depended upon a risk weighting of the exposure. For example, an exposure could have a zero risk weight in which case no capital would be required or it could have 100% risk weight in which case 8% capital would be required. Thus, if a bank made a loan of 100 it would have to have equity capital of 8% as a cushion against the insolvency of the bank.

Since the financial crisis of 2008, we are already through Basel III into Basel IV. The required capital has substantially increased. And there may be changes, and probably are, to the account below, which we will have to pick up later.

In any event a feature of Basel II was that banks have to hold capital to cover operational risk. Operating risk is the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events. It includes legal risk but not strategic or reputational risk.

Examples of operational risk

Examples of operational risk contemplated by Basel II include:

- **Internal fraud** which includes intentional non-reporting, unauthorised transactions, or position mismarking, theft, embezzlement, destruction, forgery, bribes, insider dealing on own account, impersonation, etc.
- **External fraud**, which includes theft, robbery, fraud, hacking, database thefts etc.
- Losses from and compensation for **wrong employment practices**, eg discrimination, and **workplace safety**
- Losses resulting from **negligence, client product or business conduct**, such as breaches of fiduciary duty, privacy, confidentiality, disclosure, churning, lender liability, aggressive sales, customer non-suitability, anti-trust, market abuse, market manipulation, insider dealing on firm's account, unlicensed activity, money laundering, bad advice, etc.
- **Damage to physical assets** from natural disaster, vandalism, terrorism, etc.
- **Business disruption or system failures**
- **Losses from execution, delivery and process management** such as wrong data entry, missed deadlines, accounting errors, delivery failures, collateral management failures, negligent reporting, incomplete documentation, incorrect customer records, missing client permissions or disclaimers, counterparty misperformance, outsourcing and vendor disputes.

A dismal taxonomy of human weakness and incompetence, with a less dismal sprinkling of human fallibility to which we (and our machines) are all prone, and a dash of natural risks to which we are also prone. Yet the list comes across as quite superficial and full of blind spots. You could not mount a legal risk management programme on the basis solely of this list.

Measurement of operational risk

There are three measurement methodologies for operational risk under Basel II: the basic indicator approach, the standardised approach and the advanced measurement approach.

Under both the basic indicator and standardised approaches, the calculation of capital required is crude. It is a percentage of gross income. The assumption is that the greater the income, the greater operational risk. Under the standardised approach the income is split into different business lines, and different factors, called beta factors, are applied to each business line to give a figure for the capital required. This is because it was thought that some business lines generate higher operational risk than others. The business lines and associated beta factors are:

- Corporate finance: 18%
- Trading and sales: 18%
- Retail banking: 12%
- Commercial banking: 15%
- Payment and settlements: 18%
- Agency services: 15%
- Asset management: 12%
- Retail brokerage: 12%

So if income is 100 and the percentage is 12, the bank must have 12 capital for operational risk.

Under the advanced measurement approach, the bank's own risk model is used to determine capital. In order to develop the risk model, a bank must keep and analyse lost data over a five-year period and be able to show that its models are statistically sound. The model uses the main categories exemplified above and measures the risk in money terms. The risk will often vary according to the jurisdiction.

Insurance can be taken into account if it satisfies various eligibility criteria, eg rating of the insurer, insurance term, independence of the insurer, minimum cancellation period etc. But the mitigation is limited to 20% of the total operational risk charge. There are detailed provisions about the risk model.

The measurement of operational risk does not replace the expectations of regulators for managing operational risk. For example, a Basel Committee document of 2003, "Sound practices for the management and supervision of operational risk" sets out ten principles of risk management, eg board and senior

management involvement, independence and internal audit, assessments, monitoring, reporting, contingency plans, independent evaluation, and public disclosure.

Management of legal risk

The methods of managing and mitigating legal risk are a confused field. There are some broad traditional categories of mitigants which show how limited the field still is. Some of these can be listed as follows:

- **Risk committees** Banks and corporates may have risk committees or dedicated staff covering such matters as credit risk (the risk that a borrower or contract counterparty will become insolvent), market risk (the risk that securities held by the bank or corporate will decline in value), liquidity risk (the risk that although the firm is ultimately solvent it is not able to pay its liabilities as they fall due out of ready cash), insurance risk (the risk that a liability may not be adequately insured), legal documentation risk (the risk that legal documentation is invalid or is not properly drafted to cover a likely risk), product risk (the risk that a product may cause damage or loss) and financial statement risk, ie an audit committee.

- **Cash reserves** A bank or corporation may have cash reserves against contingencies. A system of cash reserves and sufficient capital is taken to its most sophisticated form in the shape of the Basel capital adequacy standards which require banks to hold a minimum capital and to satisfy a minimum liquidity test, requirements of considerable detail and complication. Provisioning falls into this category.

- **Pricing** It may be possible to compensate for a risk by adjusting the price upwards. Realistic pricing is often prevented by a competitive market and by the fact that competitors may low-ball the price, eg, because they want the business, regardless of the risk.

- **Corporate governance** One of the main purposes of corporate governance rules, mainly intended for listed companies, is to protect the corporation, its shareholders and creditors against business mistakes and in particular to protect the corporation against an overbearing, despotic, and dangerous chief executive. In some continental European countries, the main principle of corporate governance is that there should be a supervisory board and then an executive board so that there are two tiers of control. In many countries, listing codes may require a split of the roles of chairman and chief executive, a specified proportion of independent directors, and specialised committees, eg covering nominations to the board, remuneration and audit.

- **Insurance** Theoretically everything is insurable but at a cost. Insurance is not available on commercial terms for some risks. The insurance may be capped and may be subject to deductibles. The insurance of financial assets, such as interest rates, foreign currency holdings and holdings of

equities or bonds, may be insured via derivatives, which in commercial terms (but not in strict law) are a form of insurance or hedging. In the case of both ordinary commercial insurance and financial derivatives, the firm takes the risk of the insolvency of the counterparty.

- **Contract protections against bankruptcy** These include the taking of a security interest (collateral), guarantees and the establishment of settlement netting and close-out netting.

- **Staff training and manuals** Staff can be educated in legal risks by training, by manuals setting up policies, by knowledge management systems within the firm and the like. As regards the communication of policies, many banks, for example, have both detailed and generic policies to guard against legal risks. An example of a generic policy of the Ten Commandments type would include admonitions that transactions should not be too aggressive on tax avoidance, not too aggressive on achieving accounting non-consolidation or non-recognition, not too aggressive where the transaction has no commercial point other than to save tax or to obtain an accounting advantage, and not too aggressive as against the counterparty, especially if counterparties are consumers or individuals. Detailed policies for banks can include prescribing the terms of confidentiality agreements, indemnities or cross-default clauses in credit agreements. Full-scale commentaries are possible. Documentation risk can be ameliorated by the use of standard forms produced internally or which have been developed by a market association and which are often the subject of case law improving legal predictability. But banks and corporations are not universities. It is hard to cover even a small portion of the risks, let alone everything. Then it is unlikely that the relevant staff have the time or skills to take all this on board, or to remember it.

- **Use of lawyers** The fact that legal risks are increasing internationally means that banks and corporations have an increased need to rely on lawyers to protect them. These lawyers may be external or internal, depending on the skills required and the cost. This is fine unless even the experts themselves cannot work it out. It is also expensive, an additional burden on legitimate business.

Some of these grand schemes of risk management recognise simply that there is a risk which cannot be made to disappear and which therefore requires cruder protection, eg insurance or capital adequacy or provisioning. In other cases a risk can be significantly mitigated but the above methods are far too generic. Sometimes the recommended steps are just not practical or their promoters vastly underestimate the cost.

In some cases, it is not realistic to mitigate the risks and all that can be done is to close down that line of business – an absurd result if the business is otherwise useful.

In subsequent chapters we will take up some specific mitigants applicable to the risk concerned. It will become apparent just how detailed they are and how dependent they are on being able to identify the risk precisely.

Some risk mitigants are feasible if the right methodology is chosen. An example is contract risk where a concerted programme is possible. In other cases, the achievement of reasonable risk reduction is virtually impossible outside insurance or similar. Thus project finance of power stations or natural resources or infrastructure involve so many legal and other risks in many emerging countries that the finance has to be largely insured by export credit agencies or specialist governmental insurers. In fact, project finance is the classic case of the multitude of techniques used to mitigate risks, including legal risks.

In the meantime, there is another issue to be discussed. Mitigating risks is not possible unless you know what the risks are. We explore in the next two chapters whether progress can be made in comprehending the world by an understanding of the families of legal jurisdictions and then by measuring or rating the legal systems by the use of key indicators.

Chapter 7

Understanding the legal risks of the families of jurisdictions

Introduction

One of the first ways of getting a grip on a cross-border legal risk is to understand the families of legal jurisdictions throughout the world to establish simplifying patterns.

There are distilled methods of measuring legal risk according to the families of jurisdiction. There are only three major families – the common law jurisdictions, the Napoleonic jurisdictions and the Roman-Germanic jurisdictions. If we reflect necessary sub-divisions, we end up with about eight groups. Nevertheless the groups are completely dominated by the three major groups so that if you understand the fundamental approaches of these three major groups, then you discover the formula, the key, the code, the secret to understanding all of them, including the basic legal risk. But this is subject to some important qualifications.

Most of the commercial and financial laws of the world's 320 jurisdictions have been based on a few countries in Western Europe. The reason for this is that Western Europe was economically the most dominant region in the world in the period around the 1830s, a period described by economists as the Great Divide when Western European economies pulled away from the rest.

The Western European nations concerned transmitted their legal systems by imperialism, emulation or significant influence. On the whole, countries adopting a legal system voluntarily took the latest model, eg most of Latin America, after independence, from France, partly via Spain, in the 19th century, Japan from Germany in the early 20th century, and Turkey from Switzerland in the 1920s. The Russian civil code was influenced by the Dutch new civil code which happened to be the latest in the early 1990s. People buy the latest car. The result is that now out of the 320 or so jurisdictions, more than 250 draw their inspiration from three fundamental approaches developed originally by three jurisdictions – England, France and Germany. So an in-depth understanding of those legal systems is the key.

You can understand the basic laws of these jurisdictions so far as their financial and corporate regimes are concerned, as well as other areas of law, by the use of key legal risk indicators, a topic which we will be discussing in the next chapter. For the moment what we need to know is who are the members of the particular groups and then we can discuss the characteristics of these groups by the key indicator system.

The historical classification of the groups of jurisdictions more or less holds good because the original champions had very different ideas about commercial, corporate and financial law. Although the patterns have been fragmented and eroded, the underlying bias still remains. This bias is particularly evident in relation, for example, to bankruptcy law which is the main driver of financial and corporate law.

What is a jurisdiction?

They range from enormous jurisdictions, both in terms of population and geographic size, like China and Brazil, to tiny micro states like Niue in the Pacific.

A legal jurisdiction is different from a nation state – there are currently just under 200 sovereign states. The latest sovereign states to be formed and recognised are South Sudan, Kosovo, East Timor and Montenegro. There are others waiting in the wings. Many nation states have a large number of internal jurisdictions. Thus the United States has 51 (if we include the District of Columbia) and the United Kingdom has seven. The question of legal distinctness has nothing to do with who has overall sovereignty.

The criteria as to whether a territory is a separate jurisdiction is whether the law is sufficiently different to merit separate investigation. This is a matter of degree. Some jurisdictions are completely different in their fundamentals, eg Mexico contrasted with Queensland. Others are close, eg many states in the Napoleonic group or English or American common law groups. This proximity is even more apparent in the case of large federal territories like Australia, Canada and the United States, although there is often still enough divergence to treat the individual territories as different.

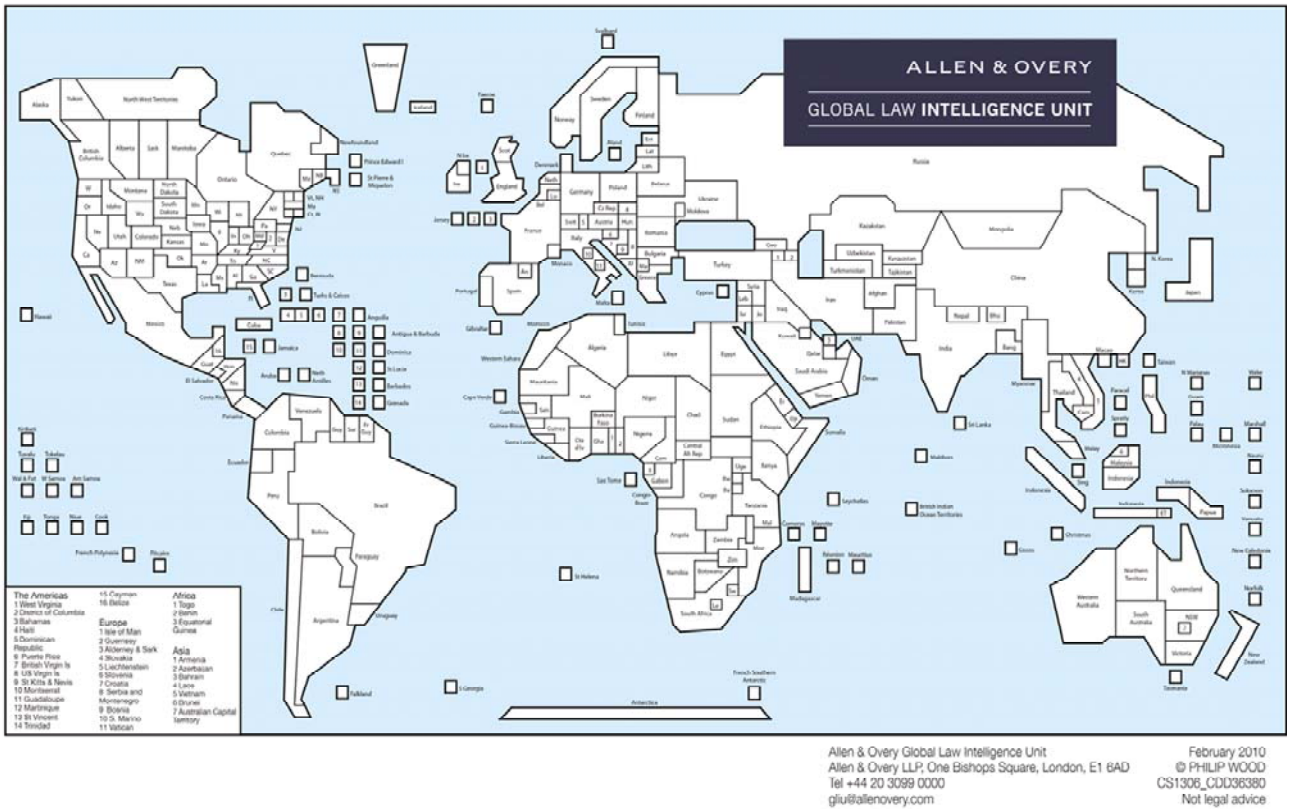
On the other hand there is very little difference between the cantons of Switzerland and the federal territories in Brazil and so it is not unreasonable to treat them as a single jurisdiction. In some cases it is arguable that some states contain many separate jurisdictions but they are often treated as a unitary for various reasons, eg mainland China, Russia and the United Arab Emirates.

The eight main family groups of jurisdictions

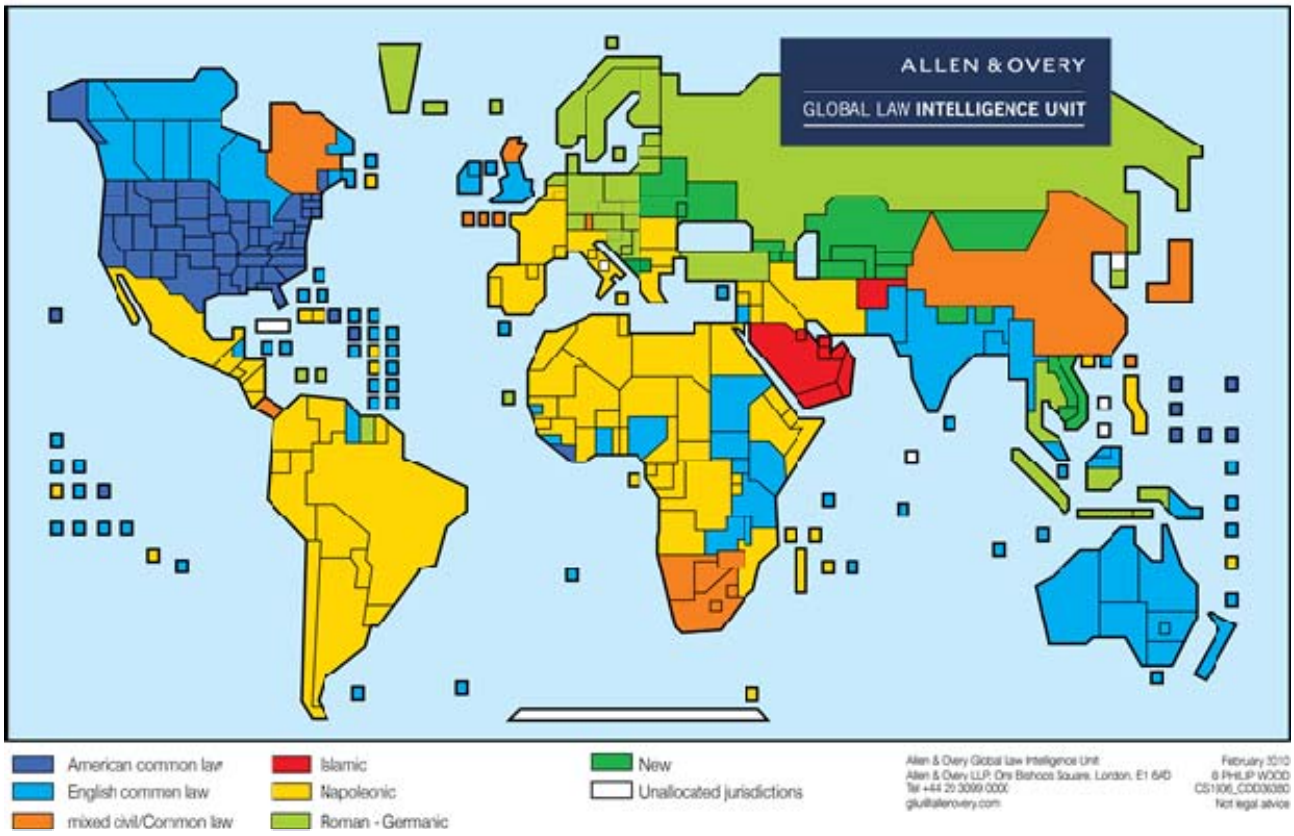
The object of this section is to describe the main family groups and indicate broadly who their members are.

The identity of the jurisdictions is shown in the accompanying "**Key map of jurisdictions**" which is followed by the map "**Global jurisdictions**" showing the main groups in a single map, which is in turn followed by maps showing the identity of the members of each group.

Key map of jurisdictions



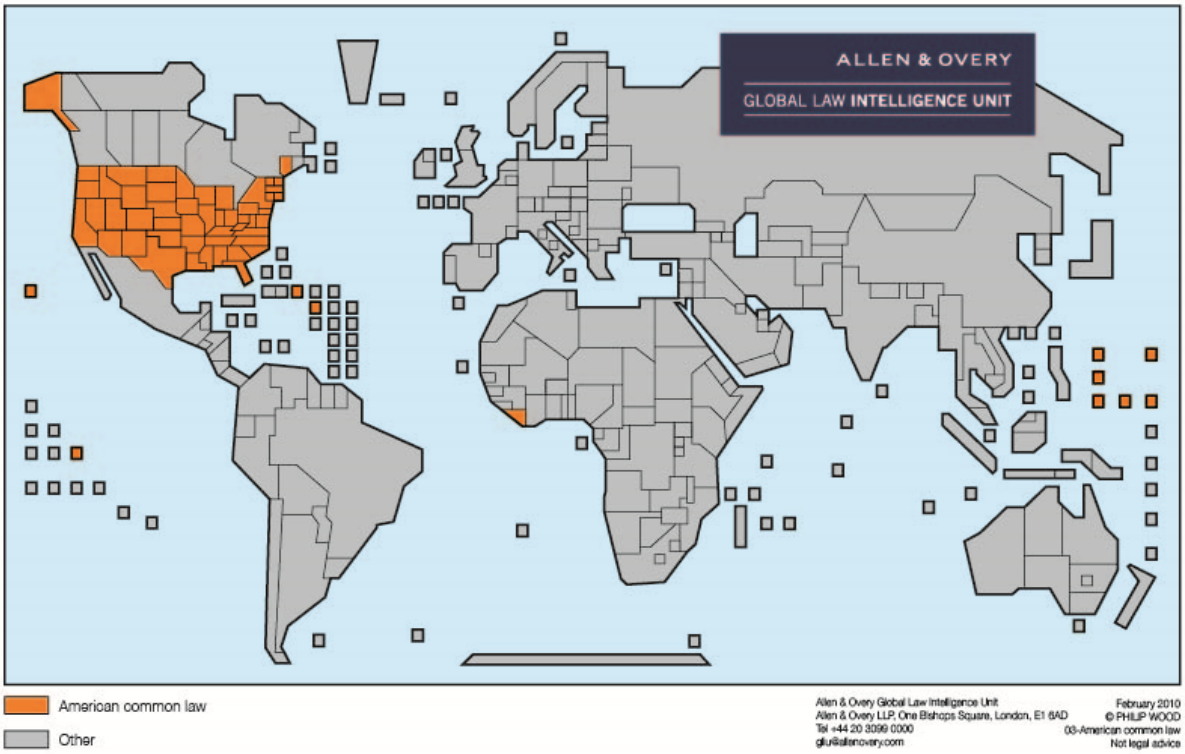
Global jurisdictions



1. American common law jurisdictions

Altogether there are about 61 jurisdictions in this group. They comprise the 51 U.S. states and territories, most of which are based on English common law, plus a few outer jurisdictions, such as the Marshall Islands, Puerto Rico and (marginally) Liberia. Although originally Napoleonic, for our purposes Louisiana is now common law so far as its significant financial and corporate law is concerned.

American common law jurisdictions



The population of the United States is around 312 million – the third largest after China and India. The population of the other ten jurisdictions is small. The U.S. is the fourth largest country in the world – about 9.5 million square kilometres – after Russia, Canada and China, but this depends on the lake and coastal count. The land mass of the other ten jurisdictions is very small.

Most of the states derived their law from England via settlement.

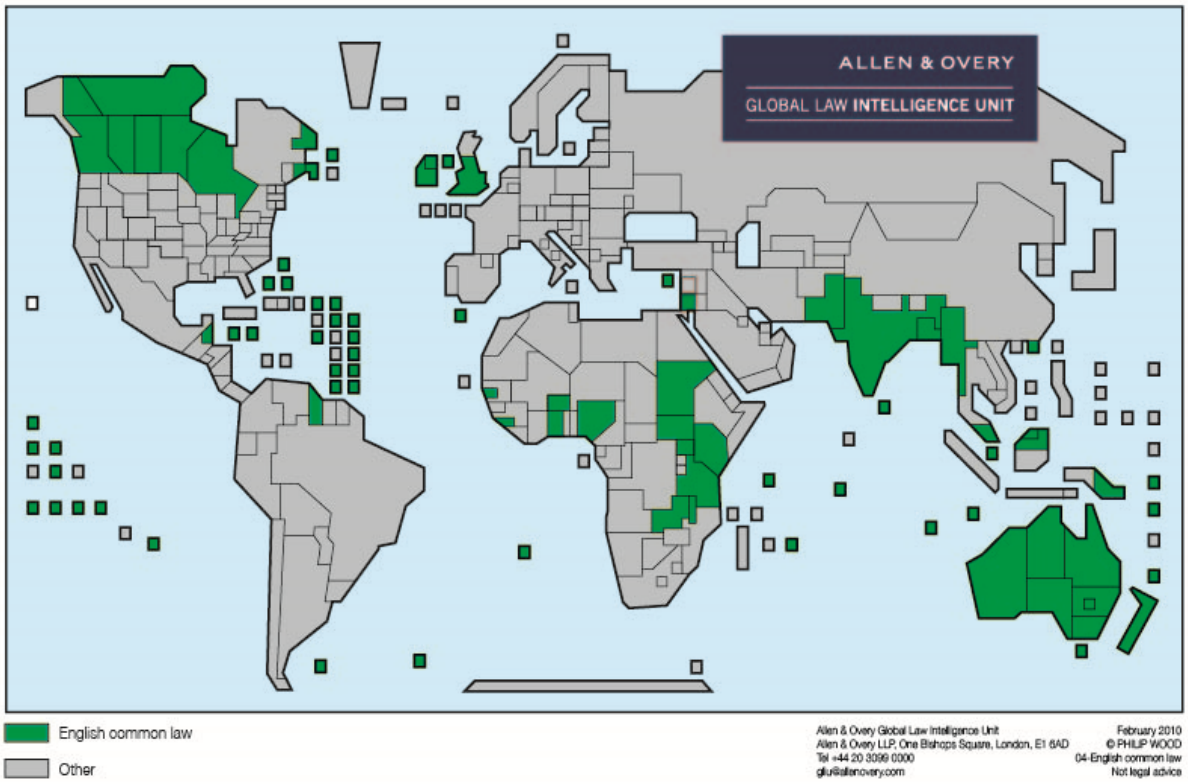
Unlike the great legal empires of the past, this group is not a territorial empire. However, in the law it is an empire of the mind and it is the empires of the mind which matter.

2. English common law jurisdictions

This group comprises about 84 jurisdictions, or 68 if one treats each of Australia and common law Canada as a unified block. The group was originally championed by England. The jurisdictions

include England itself, Australia, Canada (excluding Quebec), Hong Kong, India, Ireland, Israel, Malaysia, New Zealand, Nigeria, Northern Ireland, Pakistan, a very large number of small islands and some larger territories in Africa such as Kenya, Tanzania and Zambia as well as (nominally) the two Sudans and also Malawi and Uganda. Singapore is a member of this group.

English common law jurisdictions



There are hybrid French-English systems in Mauritius, St Lucia, the Seychelles and Vanuatu. Sri Lanka was originally Roman-Dutch and there are some differences, notably in relation to land law.

Some of the very small jurisdictions in the group are in fact extremely important in financial and corporate law, eg Singapore and Hong Kong, as well as the Cayman Islands.

The group contains about 30% of the population of the world, largely because of the inclusion of such countries as India, Pakistan and Bangladesh and is the most populous group in fact.

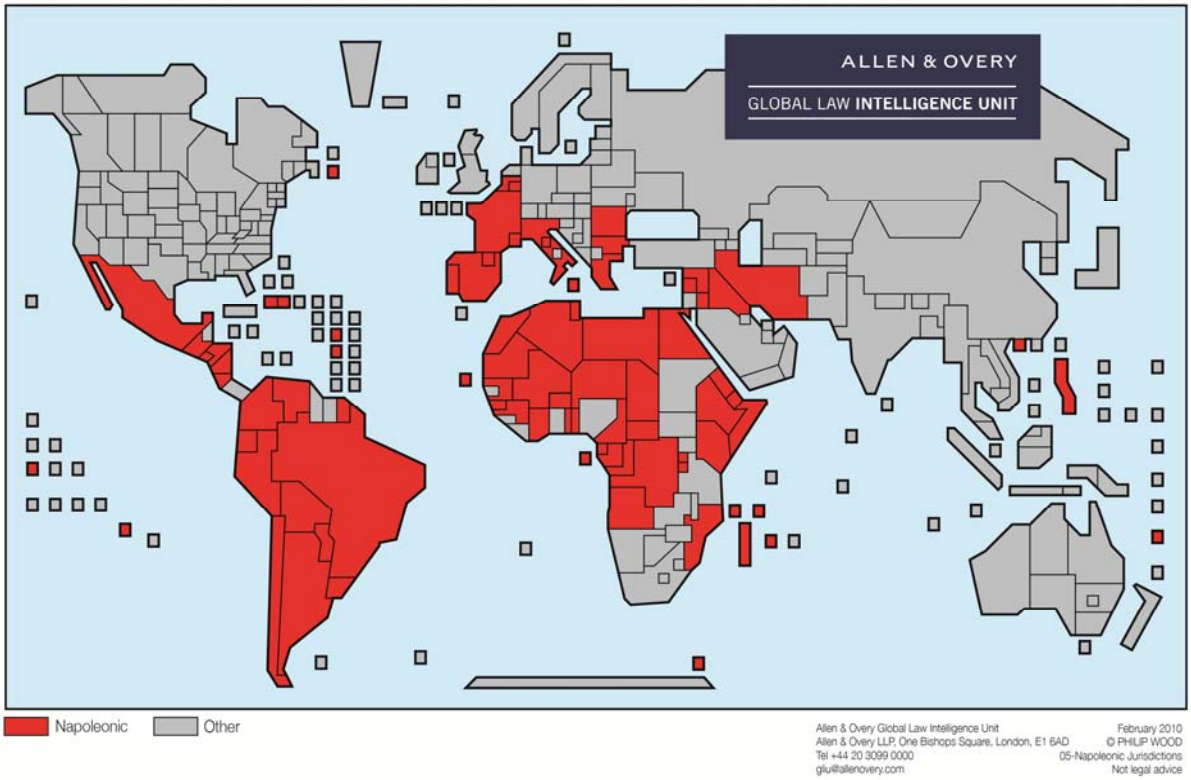
Unlike the other groups, all the jurisdictions received their legal systems via settlers and colonialism. England did not codify its legal system comprehensively and so did not have a marketable legal system in the eyes of jurisdictions wishing to reform their law. When England did codify, the codification was influential elsewhere in other groups, eg sale of goods, insurance, maritime law and negotiable instruments.

In the 19th century Britain was the leading economy in the world and England had a precocious commercial and financial law attuned to a liberal market economy – well-suited to developing countries. The main challenges for members of this group are to retain the original radical simplicity, versatility and freedom. These were characteristics which significantly decreased the legal risk for both banks and corporations.

3. Napoleonic jurisdictions

This group comprises about 82 jurisdictions drawing their original inspiration from France.

Napoleonic jurisdictions



One can divide them into sub-groups such as:

- the European Napoleonic jurisdictions, including Belgium, France, Greece, Italy, Luxembourg, Monaco, Portugal, Spain and others;
- the French island dependencies in the Caribbean and elsewhere;
- the traditional Napoleonic jurisdictions which have hardly changed their law including such countries as Ethiopia, Burundi, Angola, Mozambique, Egypt, Lebanon, Madagascar, Morocco and Tunisia;

- the Ohada Napoleonic jurisdictions which comprises 17 sub-Saharan countries in Africa which adopted a harmonised version of modern French law (Ohada is the organisation for the harmonisation of business law in Africa established by a treaty of 1993 with a common court of justice and arbitration in Abidjan);
- the Sharia Napoleonic jurisdictions which are influenced by an overlay of Islamic Sharia law, such as Iran, Iraq, Jordan, Somalia, Syria and others; and
- the Latin American Napoleonic jurisdictions.

The Philippines, Quebec and Louisiana are really classifiable now as common law jurisdictions on the key indicators.

Malta is Napoleonic-based but on some of the key indicators it should be classified as a member of the mixed civil/common law group.

East Timor was originally a Portuguese colony but its constitution provides that Indonesian law applies – basically Dutch law though it is therefore probably a member of the Roman-Germanic group. It was proposed to introduce Napoleonic Portuguese codes and it should be checked how far that proposal has gone.

The Napoleonic group is very widely represented throughout most of the world, although it has very little representation in Asia or the East. The group's most populous member is Brazil which also happens to be the fifth largest country in the world, after Russia, Canada, China and the United States. France is the largest country in the EU with a total area of nearly 550,000 square kilometres, one and a half times the size of Germany, more than twice the size of the UK and four times the size of England.

The commercial and financial law of almost all of these jurisdictions was founded on the early 19th century Napoleonic codes and bankruptcy legislation. The borrowings came via France and other countries such as Spain, Portugal and Italy.

Unlike the dissemination of English law, large parts of the world are Napoleonic otherwise than by reason of colonialism. For example, most of the Latin American countries desired unifying legal codes after independence in the 19th century and naturally turned to the main codes available at the time – from France. These codes continued to be influential in the late 20th century, eg in Kuwait, the United Arab Emirates and Jordan, partly by reason of the influence of Egyptian, Syrian and Lebanese lawyers, partly perhaps because the pro-debtor colouring of the approach appealed more to countries with Islamic objections to usury.

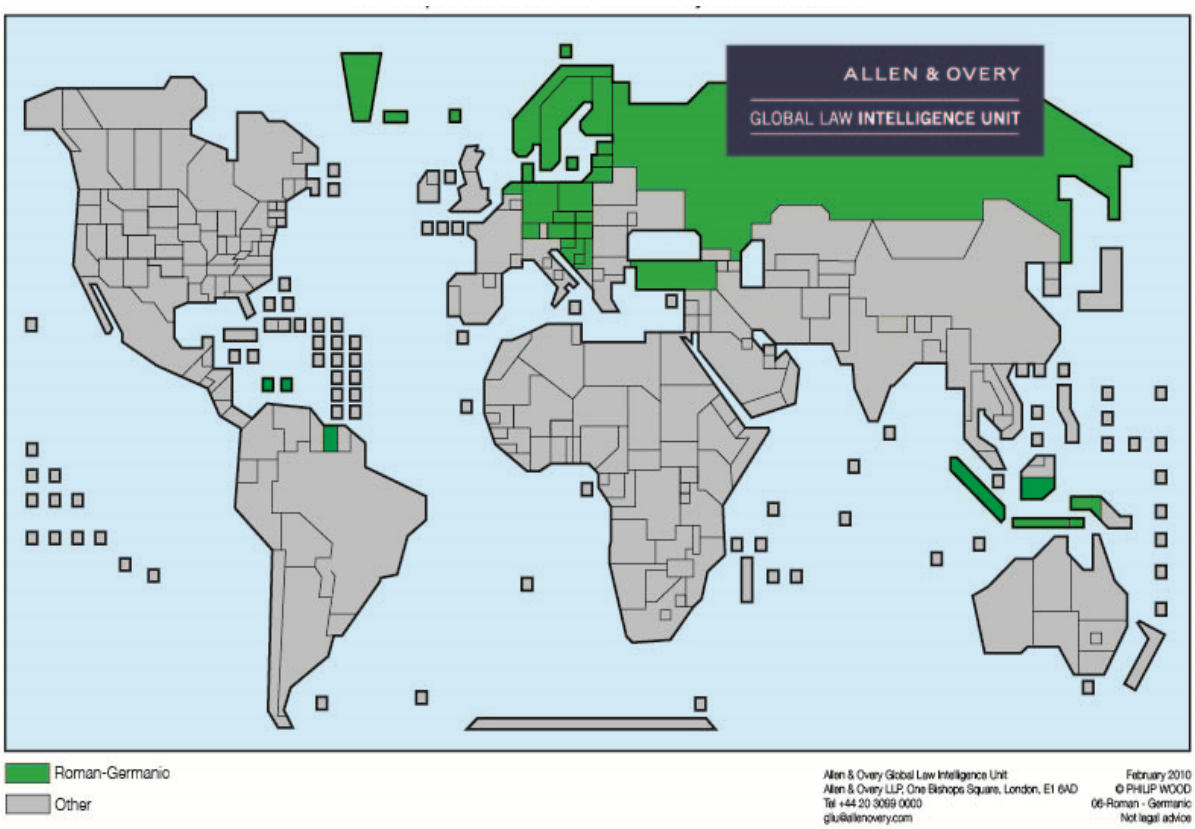
The group covers the largest land area of all the groups – nearly 35%.

The Napoleonic legal view has extraordinary charisma, precision and distilled power. The fact that 17 former African colonies of European powers were minded to harmonise their laws – the Ohada group – on the basis of the modern law of their leading former colonialists acknowledges this. The legal ideology was settled early on and in some respects there might be a case for re-storming the Bastille. Recent developments in France and Belgium in particular show a remarkable shift in the direction of protecting creditors in credit economies, as opposed to the traditional view of a debtor protection prevalent at the end of the 18th century when the codes were crystallised.

4. Roman-Germanic jurisdictions

This group was strongly influenced by German 19th century jurisprudence with significant contributions from, for example, the Netherlands and Switzerland. There are about 31 jurisdictions in this group, as shown in the relevant map. These jurisdictions include Austria, the Czech Republic, Denmark, Finland, Germany itself, South Korea, the Netherlands, Poland, Russia, Sweden, Switzerland, Thailand (doubtfully) and others.

Roman-Germanic jurisdictions



The group is predominantly a northern hemisphere ideology with substantial representation in north-western Europe, Scandinavia, the Baltics, Central Europe and the Balkans, spreading through to Russia and Turkey. There is a gap in the Middle East, but substantial representation in East Asia

including South Korea and Indonesia. China, Japan and Taiwan, though classified as mixed civil/common law, were influenced by German law.

Apart from the Southern African group of five jurisdictions south of the Zambezi river and stopping at the English jurisdiction of Zambia (the five are all treated as mixed civil/common law), there is virtually no representation in the southern hemisphere, with only Aruba and the former Netherlands Antilles in the Caribbean and with Suriname the sole representative in South America. There is no representation in North Africa.

The member with the largest population is Russia with around 145 million people. Germany has a population of about 82 million – the most populous state in Europe.

In GDP terms, the group probably has a higher proportion of jurisdictions with high capita income compared to the other two main groups.

Out of a total world land mass of about 148 million square kilometres, the group includes the largest country in the world – Russia at 17 million square kilometres. Germany, with nearly 360,000 square kilometres, is the fourth largest country in Europe, after France, Sweden and Spain.

The legal ideology originated from Roman law in Europe, transmuted into a distinctive branch of Roman law mainly by Germany.

The German ideology was transmitted primarily by the strength of the codes which have been in the works for most of the 19th century. These codes formed the basis for the legal system in Japan some 30 years after the Meiji restoration in 1867. The codes then found their way to Korea by virtue of Japanese colonialism (1905) and then into China, largely because of the influence of Japanese jurists in China in the 1930s and subsequently during World War II. It was this system which found its way to Taiwan, then called Formosa, partly by reason of Japanese conquests (1895) and bolstered on the ejection from mainland China in 1949 of Chiang Kai Shek and the Kuomintang by communist forces led by Mao Zedong.

The Netherlands contribution is also notable. The Netherlands was colonised by France in Napoleonic times but subsequently returned to its commercialised Roman roots reflecting Dutch mercantile and financial supremacy in Europe in the 17th century and after. It was this system which was transmitted by Dutch settlers to the Cape of Good Hope and was in turn carried upwards to the rest of Southern Africa.

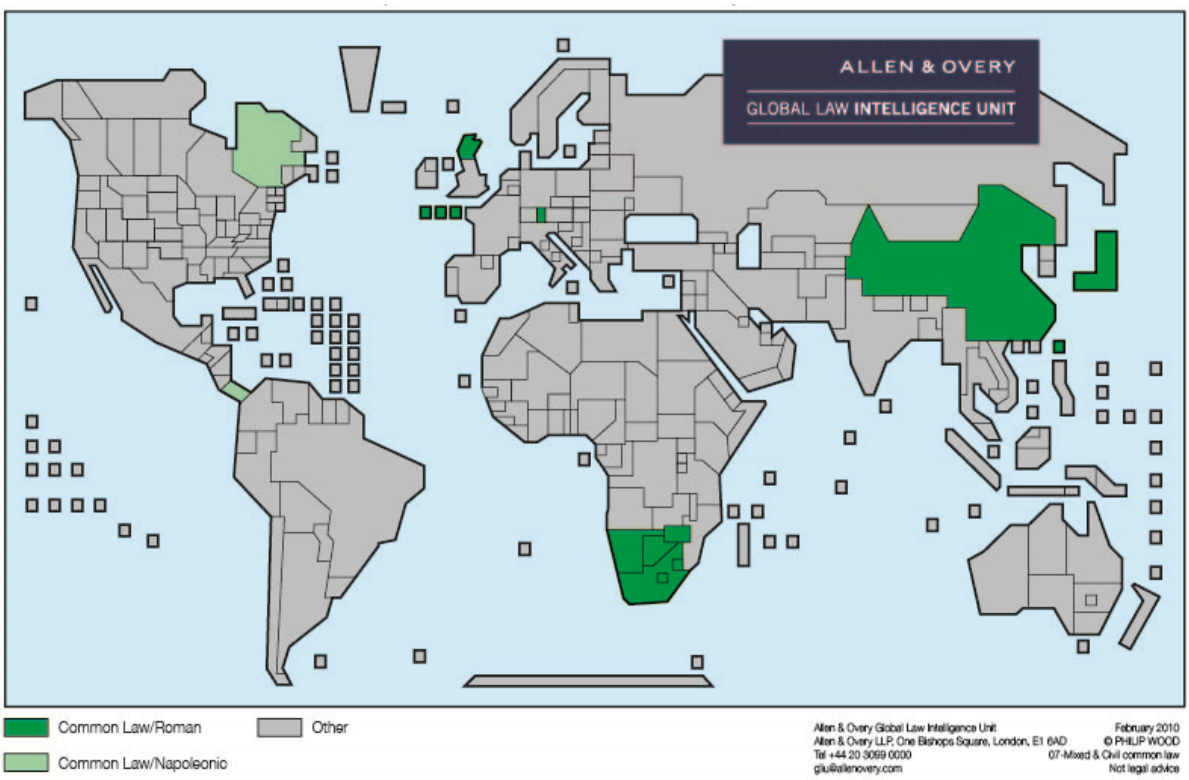
The systematic working out of the ideology of this group was an extraordinarily intellectual feat. The ideology was, and still is, transmitted entirely by the quality of the product. A distinctive contribution of the group is a systematisation of publicity for superpriority property rights, inspired

by Roman law. It was this view, amongst other things, which led to the rejection of the universal trust.

5. Mixed civil/common law jurisdictions

There are about 17 jurisdictions in this group. All of them have continental European roots but they also generally have the common law institution of the trust, plus other key indicators associated with the common law system, eg bankruptcy set-off or a wide security interest.

Mixed civil/common law jurisdictions

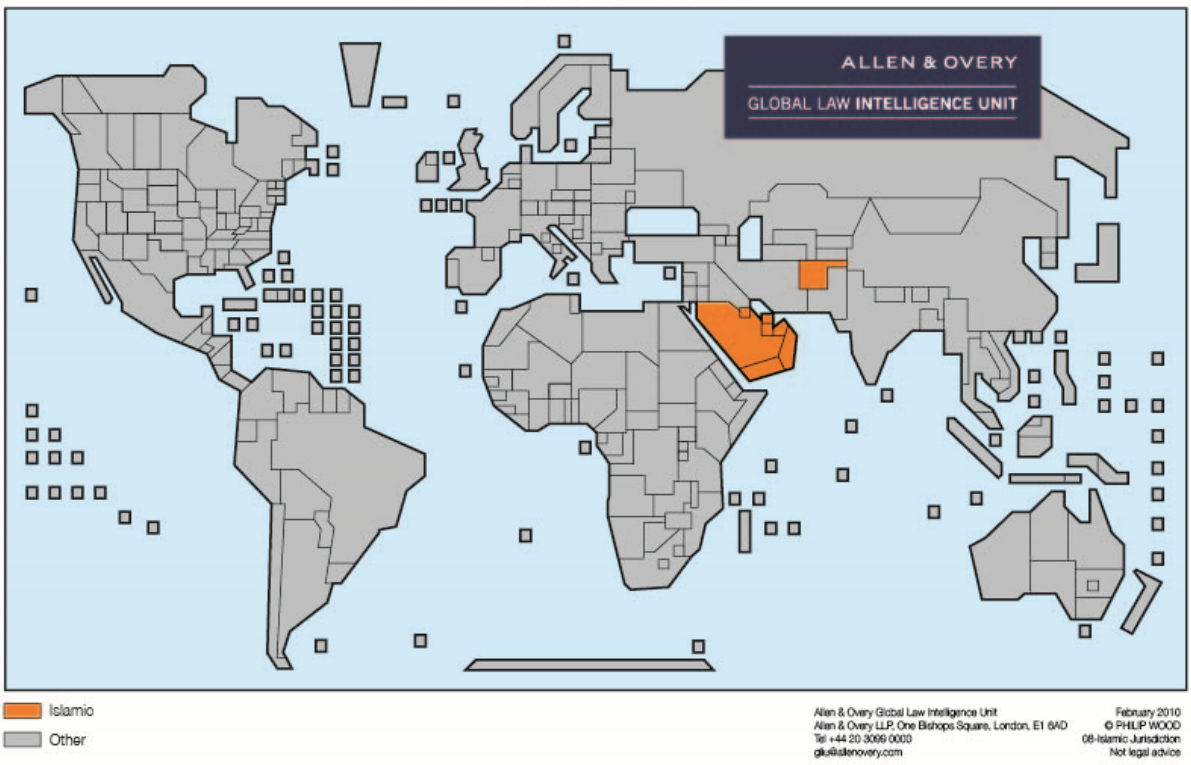


It is part of the humour of history that this group should include countries as various as Swaziland, Zimbabwe, Panama, Scotland and Jersey. The fact that it also includes both China and Japan means that it is an extremely important group. The historical origins are in fact easily explicable if one follows colonial and economic history.

6. Islamic jurisdictions

There are about eight jurisdictions in this group – Afghanistan, Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, the United Arab Emirates (technically several jurisdictions) and Yemen. A number of other jurisdictions which have a predominantly Muslim population are best placed in other groups because often the Sharia only affects personal law, not business law, eg Malaysia (English common law), Indonesia (Roman-Germanic) and Egypt (Napoleonic).

Islamic jurisdictions



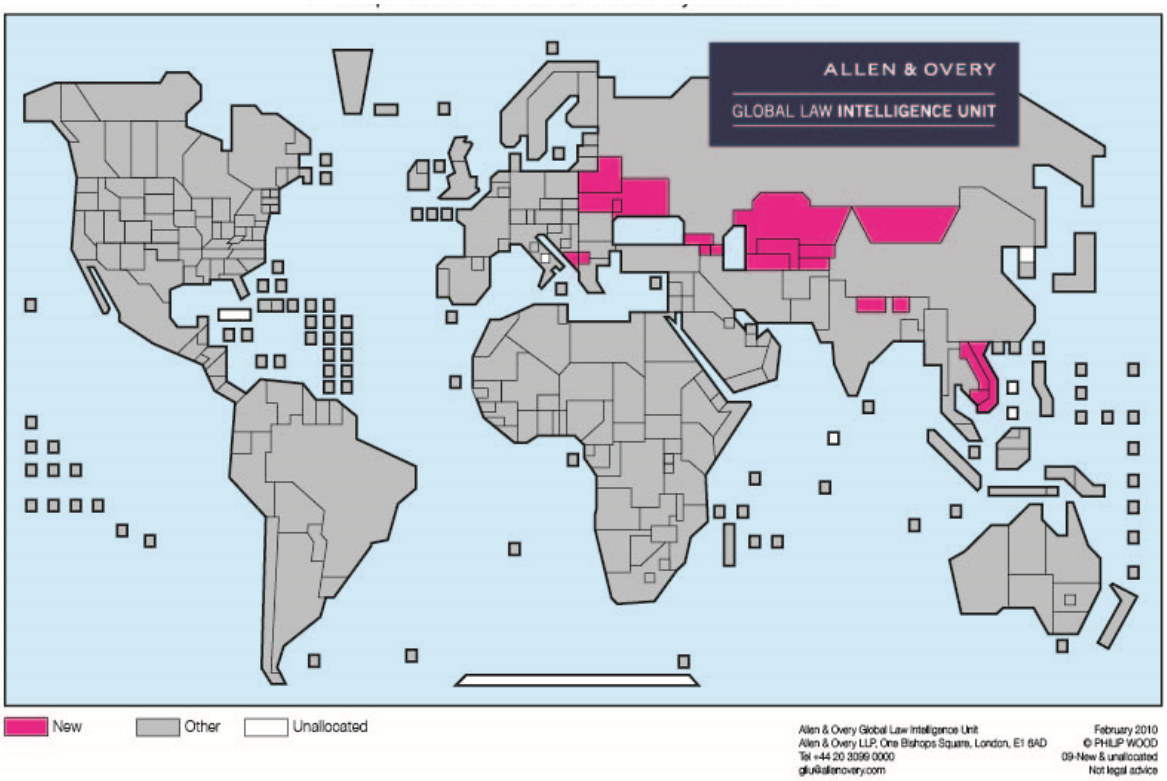
Quite a few former Napoleonic and other territories are now de facto Islamic jurisdictions although the underlying laws still remain Napoleonic. These include jurisdictions such as Jordan (classified as Napoleonic), Somalia (classified as English common law), Iraq, Syria, Iran and the Lebanon (all strictly classified as Napoleonic). Bankruptcy laws of a sort are present in some of these jurisdictions but in most cases are inchoate and extremely slim. Their position on key financial and corporate law indicators is often conjectural.

Western law had its fount in the Fertile Crescent before the rise of the ancient Greeks – the first achievement of this group. The second achievement of this group was the development of a rich body of law in the ninth century. History does not stop now.

7. New jurisdictions

There are about 19 jurisdictions in this category, sometimes called transition jurisdictions. With the exception of Bhutan and Nepal, they were formerly communist countries which subsequently adopted programmes of law reform. In many cases it would now be possible and correct to ascribe these jurisdictions to one of the other groups on the basis of key indicators.

New and unallocated jurisdictions



The jurisdictions include Albania, Armenia, Azerbaijan, Belarus, Bhutan, Cambodia, Georgia, Kazakhstan, Kurdistan, Laos, Macedonia, Moldova, Mongolia, Nepal, Tajikistan, Turkmenistan, Ukraine, Uzbekistan and Vietnam. Most of these had or still have a programme of market reform.

The jurisdictions had many models to choose from. The problem for them is that the models presented to them did not speak in unison.

8. Unallocated jurisdictions

Seven jurisdictions are for one reason or another not allocated. They include North Korea, Antarctica and the Vatican.

The high seas and outer space are the subject of a body of laws but they are not separate territorial jurisdictions. They are the commons.

North Korea is a communist dictatorship. Presumably the underlying Roman-Germanic system, via first Germany, then Japan, has been obliterated.

Cuba has been governed by a communist dictatorship since the 1960s. Unless totally overruled by communism, the underlying legal system is probably Spanish-related and therefore Napoleonic. In fact in former communist countries such as Poland, the underlying legal system was left intact but subject to overriding articles about the state ownership of land and the means of production and the

tenets of the socialist state. All one had to do therefore was simply to delete the few overriding articles.

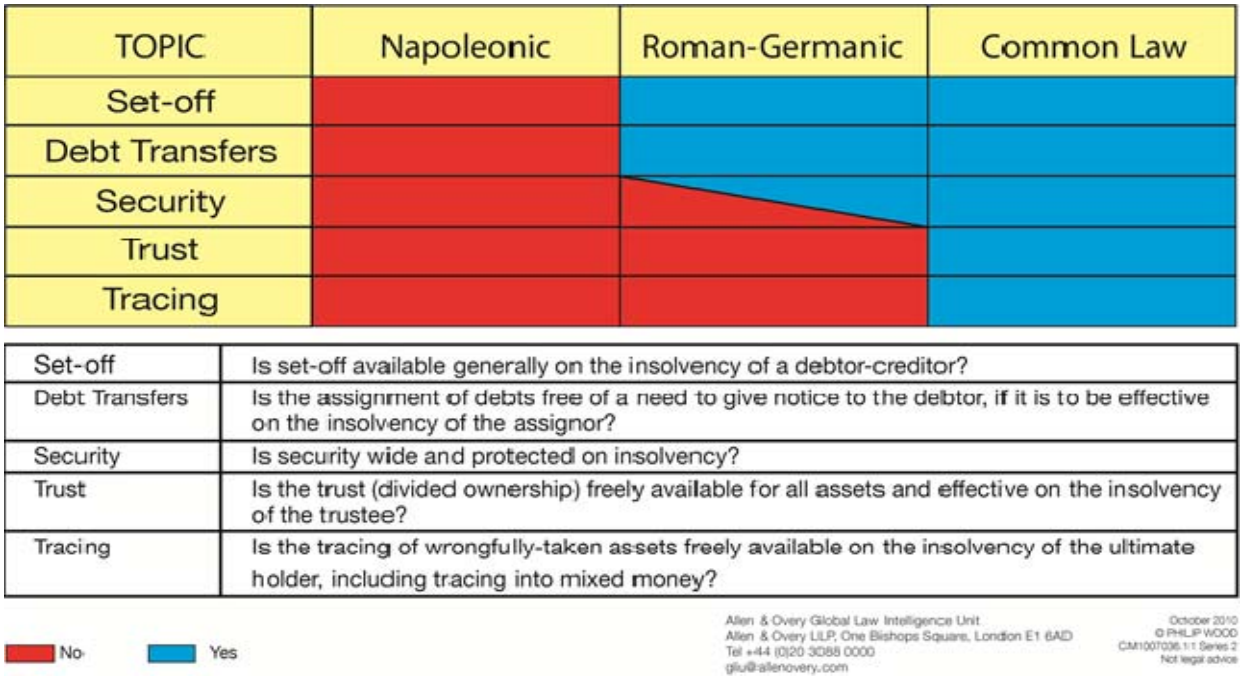
Overall orientation

If we were to take a much broader brush and blur some of the lines between some jurisdictions and amalgamate others, eg by allocating the mixed civil/common law jurisdictions and the new jurisdictions to their main inspiration, then in very crude terms a division of the world into 40% English-American common law, 30% Napoleonic, 20% Roman-Germanic and 10% of the rest would not be too far out. So at least here one has made some advance in working out what the legal risks are in terms of the ideology of the family of jurisdictions.

What has happened to the families?

Back in 1975 it would have been possible to get round the much smaller relevant numbers of jurisdictions in the world simply by knowing the content of Napoleonic, Roman-Germanic and a common law based on France, Germany and England.

1975 – World financial law: five key indicators



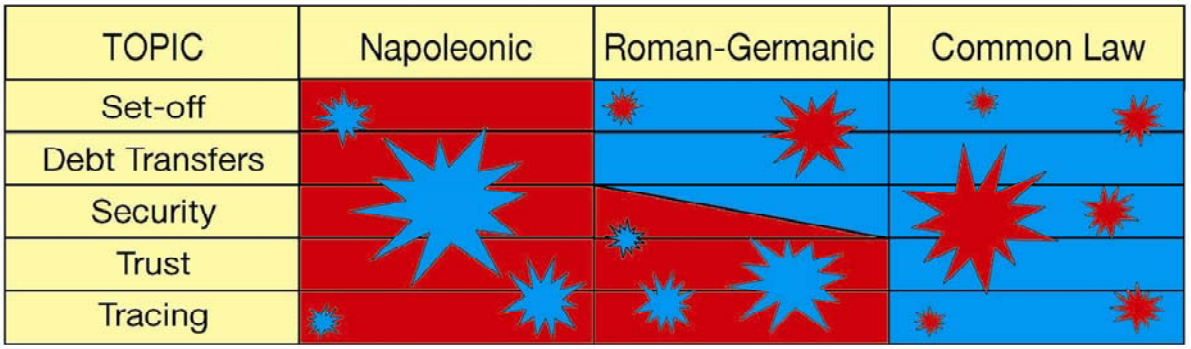
This is brought out by the chart "**1975 – World financial law: Five key indicators**". We need not at this stage go into the meaning of the five key indicators other than that in one way or the other they show the pro-debtor or pro-creditor orientation of the root legal system so far as its bankruptcy law is concerned. For example, if a jurisdiction has a very wide security interest, then it is protecting the creditors, such as banks and bondholders, as opposed to the debtors. Similarly bankruptcy set-off protects creditors of a bankrupt

because the creditors get paid by the set-off. If a jurisdiction has the trust, such as custodianship of securities, then the beneficial owners of these securities can take them out of the bankrupt state of the custodian, free of the claims of the private creditors of the custodian. If there is no trust (and there is no trust for all assets universally in most of the Napoleonic and Roman-Germanic groups), then the securities belong to the custodian and are available for its private creditors. It follows therefore that security interests, bankruptcy set-off and the trust are key indicators of the approach adopted by the jurisdiction to bankruptcy.

The table shows that, despite exceptions, the traditional Napoleonic jurisdictions were generally red on all of the five indicators, that the Roman-Germanic were blue on half of them and red on the other half, and that the common law were blue on all of them.

But if we look at the next chart "**2010 – World financial law: Five key indicators**" we see a somewhat different picture. The chart shows exactly the same key indicators but it also shows that each of the groups of jurisdictions has been broken up.

2010 - World financial law: Five key indicators



Set-off	Is set-off available generally on the insolvency of a debtor-creditor?
Debt Transfers	Is the assignment of debts free of a need to give notice to the debtor, if it is to be effective on the insolvency of the assignor?
Security	Is security wide and protected on insolvency?
Trust	Is the trust (divided ownership) freely available for all assets and effective on the insolvency of the trustee?
Tracing	Is the tracing of wrongfully-taken assets freely available on the insolvency of the ultimate holder, including tracing into mixed money?

No Yes

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In other words the original triple polarisation shown in the 1975 chart, the original triptych, has been fragmented and splintered. The old certitudes have been the subject of many and sometimes substantial explosions so that it is now much more difficult to find one's way through legal risks based on the families of law. For example, contrary to the traditional Napoleonic view, France recently adopted a universal trust and a universal security interest.

One would arrive at a different set of results in relation to the three main groups and in relation to corporate law by applying key indicators. As we shall see later, corporate law is more complicated in its interplay of competing interests than is the case with financial law.

The outlook for emerging countries

Most of the emerging countries started out with an inherited legal system based in particular on the traditional approaches of England, France or Germany or one of their offshoots. Since decolonisation, mainly in the 20th century, not a great deal happened legally in most of these countries for several decades. But over recent years there have been many calls for the reform of legal systems, especially in order to attract capital for infrastructure. Some countries have already made substantial progress in this direction, eg the Ohada group of 17 sub-Saharan African countries which have adopted a modernised form of French commercial law on a unified basis.

When we come to key indicators of financial law, such as bankruptcy set-off, the scope of security interests and the trust (custodians) it is extraordinary how diverse the solutions are in these emerging countries, especially the transition countries which emerged from communism. We shall see what a great divide there has been between for example, Russia and China in their approach to pro-debtor or pro-creditor protections. For example Russia, Ukraine and many former USSR countries are much closer to the original Napoleonic traditional model, whereas China is close to the English common law model in its pro-creditor bias of its written law – almost as if it was codifying English law. This should not be a surprise if we consider that England was a developing country when it crystallised its pro-creditor characteristics, and China is a developing country now. In both countries, capital is king.

The West has made many mistakes in its legal systems, especially over recent decades. These mistakes have been an absurd intensification of regulatory and extraterritorial law and an unjustified fragmentation of the domestic legal system by tiering or layering. One hopes that in any reforms undertaken by emerging countries, they will not make the mistakes that the West has made.

Families of law and the promotion of business enterprise

The proposition is sometimes put forward, notably by economists interested in the law, that Anglo-American legal systems are more conducive to the promotion of business and enterprise than, say, Napoleonic or Roman-Germanic systems.

One needs to be extremely cautious about these arguments. In the first place, the proposition is disproved by the facts. For example France is a highly advanced and effective industrial economy which ranks more or less equally with the UK. Luxembourg has a very ancient Napoleonic legal system – thus, the bankruptcy law dates back to 1874 – but nevertheless the country has the highest per capita GDP in the world.

Similarly, there are significant differences between both the Napoleonic and common law families when compared to the Roman-Germanic but it is evidently unlikely that these differences explain economic performance when one compares the historical economic record of England, Germany and France.

It seems to be the case that it is hard to prove that the various differences in doctrine have a massive impact on the success or otherwise of business.

The reality is that there are a huge number of variables which go towards the industrial efficiency of a country. The weighting and relative importance of those variables is hard to discern on account of the noise and volume. There are just too many factors in play to make it possible to advance generalisations about the connection between business enterprise and the written legal regime.

Nevertheless, this is not to say that some legal regimes involve bigger legal risks than others so that the potential losses incurred by individual banks or corporates in operating under one legal regime can be greater than that in others.

Legal areas not governed by a family of law

The families of law are helpful and accurate in revealing basic attitudes to finance, bankruptcy, corporate law, contracts, jurisdiction and the like. But there are some important areas of law which are not determined by the family of law. These include:

- Large parts of economic and regulatory law, such as anti-trust, financial regulation and environmental law. These tend to be driven by other factors, such as the degree of development of the jurisdiction
- Non-adherence to the basic tenets of the rule of law, such as expropriations, corruption and arbitrary despotism. These features are more characteristic of poor underdeveloped countries
- Legal inefficiency, such as very slow courts, bureaucracy, and red tape. These again are mainly characteristic of poorer countries. Legal efficiency is expensive and is often dispensed with when the people are struggling to survive
- Tax law.

Why were the main families of law different?

If we are really to understand legal risk, if we are really to understand what happened in the world and why it influences what will happen, then we have to endeavour to work out why it was that the three Western European philosophies, which covered almost the entire world, were so different in their outcome.

Although there were many influences and counter-influences, many impulses and causes and effects, the reason for the difference between the three great groups based on England, France and Germany could be an extremely simple historical circumstance.

This was the timing of the impact of the industrial revolution in relation to the timing of the crystallisation of the three great legal traditions.

The industrial revolution was first felt in England after about 1750. This happened at a time when the economic philosophy was one of laissez-faire as pronounced in Adam Smith's *Wealth of Nations* published in 1776. This propounded the theory of the invisible hand of the market. By the early 19th century when Britain had more or less been through the first stages of its industrial revolution, the ideas of total market liberalism were the prevailing mainstream consensus of policymakers, lawyers and economists. The attitude was "capital is king", "the railways must be built".

Hence if the banks wanted all of the corporate assets as security for a loan, they got it. If the banks then wanted to be able to enforce their monopolistic security in one hour by appointing a friendly accountant as a receiver, do go ahead. If the receiver fired all the directors and took complete charge of the company without any reference to the courts, please, be my guest. These 18th and 19th century lawyers had got it into their minds that it made no sense to switch off a power station on an enforcement and that the real creditors who were being protected were the depositors with banks so that protecting banks was in effect protecting the savings of the people.

However, security interests under the French system were hugely different. It was not possible to cover all the assets and enforcement was difficult, involving applications to the court and long delays. There was no concept of possessory management through a receiver. One may infer that when the Napoleonic codes were crystallised, which was in the last decade of the 18th century, the industrial revolution had not really hit France to any great degree. The people who were drafting the code were still living in the earlier agricultural world where moneylenders were small and an irritant and where trade and finance were somewhat contemptible. It did not occur to them that one needed security interests for giant power stations nor did it occur to them that one needed bankruptcy set-off for payment systems or for counterparty risks between banks. Why would it have done? There were no big power stations requiring huge amounts of finance to be secured and there was no such thing as large amount payment systems. Trade could get along quite well enough without bankruptcy set-off.

When we came to the Roman-Germanic system, the industrial revolution had certainly swept through Germany – the codes were in the works from about 1850 onwards although only promulgated in 1900. However, the really important law – the bankruptcy law – was enacted in Germany in 1879, at the height of the industrial revolution in Germany. It was no surprise therefore that the Roman-Germanic system, as evidenced in the great codes and in the bankruptcy legislation, had a distinct creditor bias in order to

encourage capital. On the other hand the codes were drafted by conservative academics immersed in Roman law and it was the influence of this backward-looking academic approach, with its somewhat aristocratic disdain for trade and commercial business, which resulted in the Roman-Germanic system being roughly 50/50 on pro-creditor and pro-debtor attitudes – somewhere in between the Napoleonic and the common law view.

Other factors in the development of legal systems and their bias included religious attitudes to usury, the depth of the credit economy which reflected economic growth as spurred by the industrial revolution (banks, capital markets), the significance of agriculture in the economy (agricultural interests were typically anti-trade, anti-money lending), the frequency and severity of economic depressions (eg the Great Depression of the 1930s), the impact of abusive scandals from the South Sea Bubble to 21st century corporate collapses, exceptional legal leaders, herd behaviour, historical traditions and a great many others.

Why then did these 19th century views cling on for so long – for nearly 200 years?

The reason seems to be that all three of the philosophies were extremely successful. A successful legal regime is almost as indelible in its basic propositions as a successful religion. Once the ideology takes hold, and especially if it originally had compelling content at its core, it becomes resistant to change, even if the case for change resulting from changed circumstances is overpowering. A detailed comparison of the three great camps shows an adherence to a historical tradition which cannot possibly be explained by real differences in current need or current economic circumstances or current culture.

It would be absurd to suggest that the divergences reflect current attitudes and a diversity in the three countries, eg that the current actual business culture in the 21st century in France is wholly different from that in England, as the analysis would suggest. These two countries used to own each other, they are now advanced industrialised countries with a common outlook in all material respects in our field. The sharp contrasts in their legal systems are the products of history – path dependence as the economists say.

It would also be absurd to suggest that the three groups are fundamentally different throughout. They are substantially similar across large territories of law, especially contract, and their fields of law are extremely sophisticated, highly developed and responsive to the needs of the arena.

Nevertheless, the triple polarisation of the early 19th century which we have tracked as happening around 1830 as a symbolic date, still remains a significant contour of the legal landscape, despite many erosions and weathered cracks.

Progress made in harmonising the three great camps is evident to some degree but on the key issues they still remain substantially as great and monolithic blocks, with their backs half-turned to each other. It is these fundamental differences, especially when translated around the world and adjusted by a nudge here and there

so as to confuse the picture even more, that results in unexpected ambush, unexpected legal risk, unexpected losses.

When we come to the law and the risks that the law generates, the accumulated wisdom of history is not to be lightly disregarded. But we should not forever be in its thrall.

Chapter 8

Measuring legal risk by legal risk ratings

This chapter discusses the use of legal risk ratings to measure and assess the extent of legal risk across jurisdictions. The concept is intended to achieve a rapid, visible and dramatic method of conveying the extent of a legal risk without the obscurity of words and figures. The result is achieved by colour-coding.

Problems of measurement

It is not possible to measure whole legal systems comprehensively. A legal system is contained in vast libraries with rows and rows of books and huge quantities of data on computers.

Nowadays in most developed countries it would not be feasible to go through all that, even if one had a large team of experts toiling away in libraries and chained to their laptops.

It has already been explained that there are around 320 separate jurisdictions in the world, encased in just under 200 sovereign states. The need for a measured assessment and rating of the risk of jurisdictions arises from a number of crucial developments. The first is that nearly all of the jurisdictions have entered the world economy, with only a handful still remaining sulkily in the wings. The second is that the pace of legal change is very rapid, so the law is volatile. The third is that the law is fragmenting and splintering internationally and, although there may be generic trends, the position on the ground is one of increasing complexity and schism. The fourth is that regulatory law is becoming much more intense and aggressive.

The result is that international businesses have to deal with an extremely intricate and risky legal environment across the world. The object of rating legal systems is to help international firms to cope with the legal risks so as to be in a better position to manage them.

A daunting aspect of this endeavour to measure legal systems is the massive volume in detail of the rules of law in most jurisdictions. A method therefore has to be found of reducing the huge volume to manageable proportions and seeking to make some sense of it. This requires highly specialised and focussed techniques. It is the purpose of this chapter to explain one of these techniques – legal risk ratings by the use of key legal indicators.

Key legal indicators

The use of key legal indicators involves a precise taxonomy of crucial criteria in a particular field and the selection from these of key indicators. When Mendeleev composed the periodic table of the elements, he

ranked them according to their atomic weight. Although unknown at the time, this ultimately reflected the number of electrons in the shell of the atom, the essential feature of an element's behaviour. If he had not selected the right criterion, there would have been no periodic table. Similarly, the great 18th century Swedish botanist Carl Linnaeus correctly selected the key criteria for differentiating between plants – related to their reproductive organs, not their colour or shape or prickliness. All future classifications in the organisation of the subject depended upon this taxonomic work. The same technique applies to the law.

The key indicators which should be selected to measure legal systems and legal risk should have the following characteristics:

- They must be **economically important** in the sense that they involve large amounts and are fundamental in business deals.
- They must be **symbolic** or representative of the legal approach as a whole in the particular area of law concerned, such as banking law or corporate law – they must function like litmus paper which comes up blue or pink according to whether the liquid is alkaline or acidic.
- They must be **measurable** with reasonable precision, and not waffly factors which are either too vague or too subjective or are a collective of too many variables.

For example, financial law involves a collision of interests between debtors and creditors. Usually, the main issue is the impact of insolvency. Insolvency is a destroyer, a spoliator. Because there is a winner and a loser, a victor and a victim, many of the most striking aspects of financial law flow from bankruptcy attitudes, eg whether the bankruptcy law is creditor-friendly or debtor-friendly. Two examples are the availability of wide security interests and the availability of bankruptcy set-off, both of which reveal a creditor-friendly approach.

Bankruptcy is therefore the major driver of financial law and yields a significant number of important criteria. It is from these criteria that the key indicators can be chosen when we are trying to demonstrate the overall approach of the financial or banking law in a jurisdiction, outside regulatory law.

Similarly corporate law is intricate and often unexpected. The reason is that indicators of corporate law are not just based on a straight line between debtors and creditors but involve a triangle of three main interests whose aspirations collide.

These three interests are: (1) creditors, (2) shareholders and (3) management in the form of directors. Most aspects of corporate law result from the attitudes of the jurisdiction as to which of these three the legal regime supports in a particular contest.

We will be discussing some detailed applications of the straight line in financial law and the triangle in corporate law later.

Also, as we will later discuss, it is important to distinguish between black letter law or the **written law** or the law on the books from the application of the law by the judicial and regulatory authorities in the country concerned, typically issues about the rule of law and the efficiency of the **legal infrastructure**. For example, the law of Congo Kinshasa and the law of Belgium have similar Napoleonic roots but the application of the law is very different. The law in Sierra Leone is based on English law but again the outcome in Sierra Leone is different from the outcome in England in terms of how the law is applied. One can find multiple examples: the law of Indonesia is based on Dutch law, the law of Turkey is based on Swiss law, the law of Brazil is based or Portuguese law.

In each case one has to take into account the legal infrastructure of the country. Normally poor or emerging countries cannot afford an expensive legal infrastructure compared to rich countries. If we were to bundle all these levels – the written law and how it is applied – we would just get a blur, a noise. This is why the frequent reference by economists to the importance of "contract and property rights" or to "institutions" is a broad-brush generalisation which really doesn't say anything and is of little value in carrying out an actual measurement which is useful in the real world to banks and corporations.

Similarly there are problems about measuring vague cultural characteristics, eg whether a jurisdiction is populist and therefore hostile to business and banks, or is insular and xenophobic and therefore antipathetic to foreigners, or is despotic and therefore favours arbitrary government power as opposed to the rule of law. These generalisations are highly relevant and sometimes complete showstoppers and so they must be measured as best we can. Still they are no substitute for the actual content of the law which must be the starting point. It is only by a meticulous method on the detail that we are able to justify the generalisations which might otherwise be prone to prejudice and error.

The technique of using key indicators has possible defects, amongst them:

- The indicators may not in fact may be representative or symbolic.
- The key indicators are sometimes general and involve many variables and so may not be sufficiently detailed.
- The key indicators may be like the models of financial quants, in that they are a simplification and not reality, because reality is much too complex.

Irrelevant indicators of legal regimes

There are a number of features of legal systems which are often cited as being critical as key indicators of differences, but which are considered unimportant.

The two most often quoted as differentiating civil from common law systems are codification and the doctrine of case law precedent, ie that courts are bound by previous decisions. In fact if one examines the evidence, these features are practically irrelevant. As to codification, this indicator mainly describes how the law is written down, as opposed to what the law actually says. It is form, not substance. Further in most commercial states, the most important areas of the law are codified, especially bankruptcy, company, sale of goods and property laws. It is only subjects like tort law or contract law or agency law which are not codified in most common law states.

Also there are some common law states which have extensive codifications, such as India and California.

Despite codification, in civil law states a vast amount of case law has been necessary to amplify the statements in the code. For example, almost the whole of tort (delict) law in France is based on a single article in the civil code.

The other characteristic said to distinguish common law and civil systems is the doctrine of precedent of binding judicial precedents. This does not seem to be a useful indicator in our area. This is because in all advanced states the courts pay regard to the decisions of higher courts, even though they are not strictly bound by them in most civil law countries. It is not a prudent strategy for a judge in a junior court to decline to follow a decision of a court of appeal or supreme court since a contrary decision will simply be overridden by the higher court and the judge will come across as a loose cannon who is not keeping to the party line.

Even in common law countries, the doctrine of precedent is quite flexible. The Supreme Court in England does not necessarily follow its own previous decisions. Further, the courts in common law countries are past masters at distinguishing other decisions which they find inconvenient for the case in hand by pointing out differences between the precedent circumstances and the circumstances then before the court. This hair-splitting amounts to an erosion of the strict doctrine of precedent. In any event courts of the same level normally do not have to follow each other.

So the degree of adherence to precedent is notoriously difficult to measure and is everywhere wobbly. All one can say is that there is a difference in emphasis about binding judicial precedent. This is hardly sufficient to delineate a chasm between groups of jurisdictions. Although it is sometimes asserted that in civil law systems the absence of a strict doctrine of precedent leads to greater unpredictably, one doubts whether this can in practice be taken too seriously.

Rating the legal indicators

Economic statisticians use figures, eg for GDP and productivity. Credit rating agencies use alphabetical symbols, eg AAA for the best investment grade and others for non-investment grade and potential default. The method adopted here is to use colours which convey the data in a striking and visible way.

The basic colours are **blue**, **green**, **yellow** and **red**, sometimes with intermediate shades.

As regards the written law, **blue** is free or relaxed in the sense that the law does not intervene and that the parties can do what they like. **Red** is restrictive or not allowed in the sense that the law intervenes intensely and restricts the freedom of the parties. The purpose of this spectrum or continuum is that one does not have to specify what is good or bad, what is the right legal policy and what is wrong. That is inevitably a matter of judgement on which there could be many opinions.

It therefore does not necessarily follow that blue is good and red is bad. For example, many people would consider that environmental law should be intensely restrictive on conduct in order to reduce the risks of pollution. That would mean that an intense environmental regime would be red for the jurisdiction concerned. That is not a judgement as to whether the environmental law is good or bad, only that the law intervenes.

Similarly in relation to takeovers, the UK has a highly regulated set of rules governing public takeovers and would therefore probably be coloured yellow over the four colours. On the other hand the United States might be coloured green or even blue on this criterion because public takeovers are not regulated to anything like the same extent in the U.S. Again, the colour coding does not indicate whether the policy is good or bad, only whether the parties are free or not free.

One could say that there is an implied policy judgement, ie that freedom is good and therefore blue and that restriction and despotism are bad and therefore red. This is an understandable point of view because the reality is that in most cases the intervention of the law itself creates a risk because if the parties do not comply, then there is a risk of either criminal or civil sanctions in the form of damages or the like. Also, many people instinctively prefer freedom to control. Yet freedom can be chaotic anarchy, and control can be discipline and good order. Notwithstanding these points, a system based on the degree of legal intervention seems to achieve the best neutrality that is available in the circumstances on policy issues.

To summarise, in the case of the written or black letter law, the colours could have the following meanings:

Blue is relaxed, open and free

Green is quite free

Yellow is quite restricted

Red is restricted, controlled, not permitted

In the case of the measurement of the different quality of legal infrastructure, the colours could have the following meanings:

Blue is good legal infrastructure

Green is quite good

Yellow is quite weak

Red is weak legal infrastructure

The bands are quite broad, not as refined as, say, the 20 or so notchings used by credit rating agencies with their double letters and pluses or minuses. The main advantage of the broad bands is to condense, reduce, synthesise and distil the information so as to find the patterns, discover the formulae. This rules out final distinctions which are often difficult to make. Each topic is often not susceptible to the rigorous mathematical precision of scientific experiment and the use of hard numbers can convey a wrong impression of certainty and accuracy.

The colours are a substitute for alphabetical rankings (A, B, C, D) or numerical ranks – 1, 2, 3, 4.

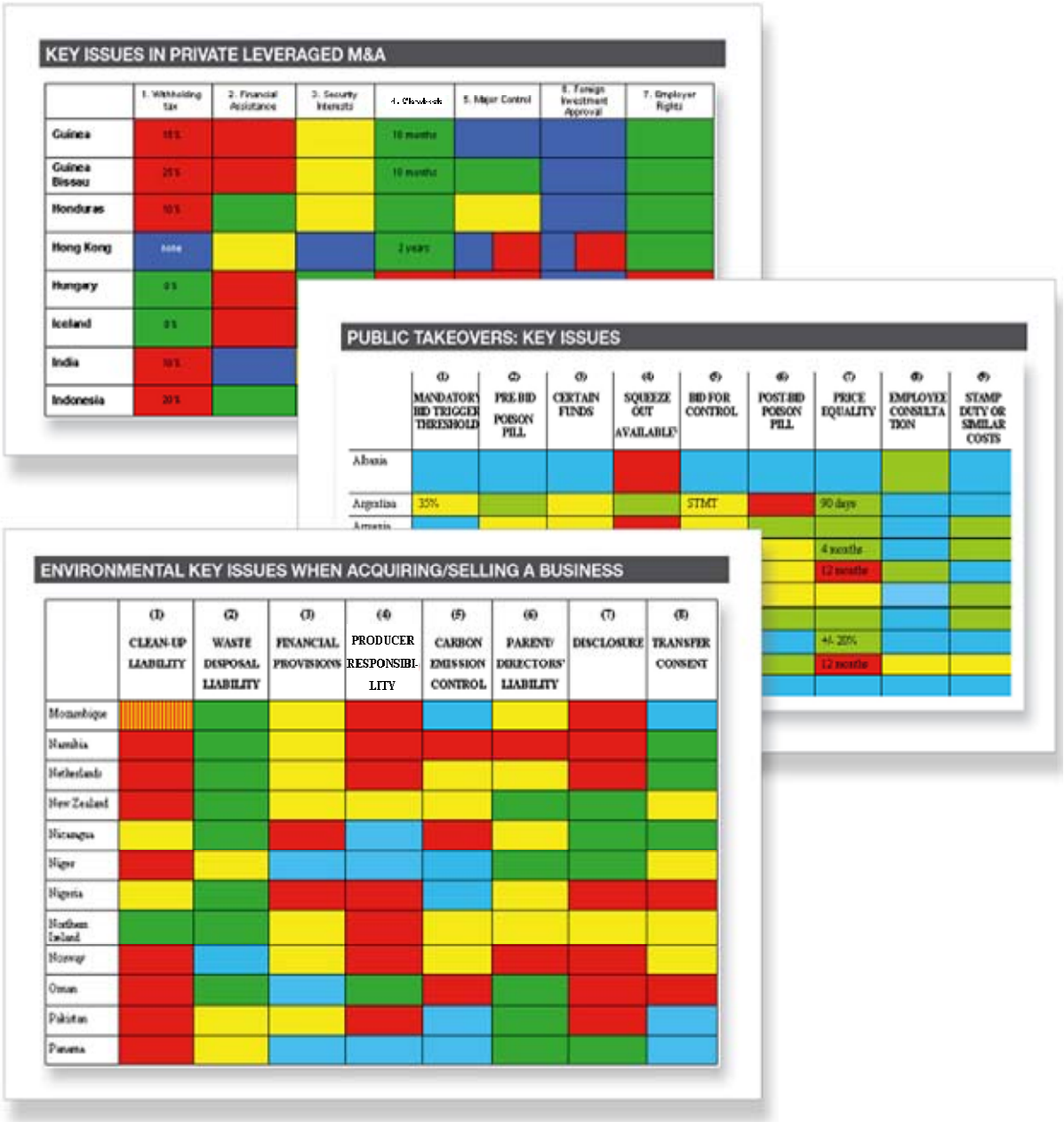
The colour-coding is much more dramatic and striking than letters or numbers. Colours deliver an immediate strategic overview and a synthesised rapid method of comparison between jurisdictions.

The broad method of colour-coding works reasonably well for issues represented in maps and charts which explore a single criterion, such as the availability of bankruptcy set-off. For those issues which measure many criteria, eg the overall attitudes to security interests, the weighting of the numerous criteria – which may be as many as 20 or 30 – inevitably leads to subjective judgements which may not accord with objective reality.

In addition it is not just the number of variables which can cause blurring and unstable measurements. One also has to consider the application of the key indicator to particular circumstances which can differ.

The technique of legal risk ratings by the use of key indicators is discussed by a review of selected risks in the following chapters.

For the moment, we illustrate the technique by reference to excerpts from 150-country tables in two Intelligence Unit surveys, the first a survey of private leveraged mergers and acquisitions of September 2010, and the second a survey of environmental law in 2011. In each study, the methodology was to take a number of key indicators and to colour-code them. In the case of leveraged deals, these were key transaction issues, such as withholding tax and the ability to secure the acquisition finance. Environmental law was split into key factors. In addition, we show an excerpt from a partially completed survey on public mergers and acquisitions.



The results of each variable were then tabulated in a world map accompanied by an international commentary on that point, so as to avoid duplication.

The relationship firms around the world who provided the information wrote a very brief commentary on their jurisdiction – not a law book, otherwise it would never have been done.

You do not get detailed information from this. Detail would run to many thousands of pages – not feasible. But the flagging method is some progress.

Chapter 9

Bankruptcy legal risks

Bankruptcy risk generally

Insolvency law is the root of commercial and financial law because it obliges the law to choose. There is not enough money to go round and so the law must choose who to pay. The choice cannot be avoided, compromised or fudged. In bankruptcy, commercial law is at its most ruthless. It must decide who is to bear the risk so that there is always a winner and a loser, a victor and a victim. That is why bankruptcy is the most crucial indicator of the attitudes of a legal system in its commercial aspects.

Bankruptcy has a profound effect on normal legal relationships. Bankrupts and their creditors are disqualified from working. Property is seized and sequestrated. Assets are expropriated without compensation. Contracts are shattered and their terms interfered with or negated. Security interests are frozen or avoided or debased. The cost of credit is increased or credit – the lifeblood of modern economies – is withdrawn. People lose their jobs and their pensions. The collapse of banks and insurance companies destroys other banks and corporations and destroys the savings of the citizen. The economy of the state itself may be sapped.

Bankruptcy is the great driver of legal change. If a large corporation like Enron becomes bankrupt, which it did in 2001, the reaction is to tighten up on corporate governance codes and legal duties regarding financial statements. If banking systems become bankrupt, as they did in 2007-2008, the reaction of the legislature is to introduce more laws, law in profusion.

If the bankruptcy law protects one set of creditors of a debtor then other sets of creditors are prejudiced.

The twin competing policies of bankruptcy law are the protection of creditors and the protection of debtors. Insolvency law is preoccupied with the collision of these interests and who to protect. These labels are ambiguous because, for example, the protection of creditors may also incidentally protect debtors where a universal security granted to a bank leads the bank to postpone insolvency because the bank is safer for longer. Similarly, the protection of debtors may also protect creditors, eg a corporate reorganisation may produce a better return for unsecured creditors than a liquidation.

The bankruptcy ladder of priorities

One of the most fundamental sources of legal risk in relation to bankruptcies is the ladder of priorities. The proposition that bankruptcy involves the pari passu or pro rata or equal payment of creditors, each

proportionately out of the pool of the bankruptcy state according to his debt pro rata, is not true. Even the most cursory examination of bankruptcy internationally shows that this pari passu rule is nowhere honoured. On the contrary, creditors are paid according to a scale or hierarchy or ladder of priority. Nowhere is there a flat field, but rather an intricate series of steps as creditors scramble for a higher position, gasping for more air. Everywhere there is a ferocious fight to survive, to escape drowning in the dark swirling tides of rising debt, to breathe in the squeezed bubble of oxygen at the top.

So important are the priority steps that in most insolvencies the pari passu creditors get little or nothing and it is only the priority creditors who get paid.

Hence in an assessment of legal risk, it is crucial for a bank or corporation to work out where their claims will stand in the priority stack, in the priority ladder.

Banks are preoccupied with the bankruptcy risk. Most of the provisions of loan documentation are driven by the monitoring and consequences of deterioration in financial condition. By contrast, the management of non-financial corporations is typically not nearly so interested in bankruptcy legal risks. They become interested if a counterparty fails or if their own company gets into financial difficulties.

A summary of the ladder

The bankruptcy ladder usually comprises at least six main ranks or rungs or steps, as follows:

(1) **Super-priority creditors**, mainly secured creditors, creditors under title finance agreements such as repos, creditors with a set-off, and beneficiaries under a trust.

(2) **Priority creditors** which include not only the old favourites of the taxman and employees' remuneration but also post-commencement new loans trumping existing creditors and the costs of running a company during a reorganisation, which may go on for years. The interrelationship between these priority unsecured creditors and the super-priority secured creditors is in practice of great importance internationally because in many jurisdictions the priority unsecured creditors trump collateral.

(3) **Pari passu creditors**, including unsecured bank loans and unsecured bondholders, as well as trade creditors. Their lot is not a happy one since experience has shown that the dividends payable to this group, after paying super-priority and priority creditors, is either nil or some small percentage – often the value breaks in the middle of this class.

(4) **Subordinated creditors**, these include creditors who are subordinated for misconduct, such as the U.S. equitable subordination, post-insolvency interest, consensually subordinated creditors, creditors without a formalised document in some Spanish-influenced jurisdictions (not Spain any longer) and equity shares.

(5) **Expropriated creditors**, a class which includes late claimants who submit their proofs of claim outside the bar date, and sometimes claimants in respect of tort. A very important member of this group are foreign currency creditors since in virtually all countries foreign currency claims are converted into local currency at the commencement of the insolvency proceedings. The frequent result is that, if the local currency is depreciating very rapidly, as it often is if there is a depression, then the foreign currency creditors can find that their nominal claim is reduced to a fraction of what it was if there is a long insolvency. This near universal rule means that foreign currency creditors of a domestic corporation have a strong incentive not to permit local corporations to go into bankruptcy proceedings. This gives debtors significant bargaining power.

It is worth dealing in more detail with the three main super-priority creditors – creditors with a set-off, secured creditors and trusts.

Insolvency set-off

If a set-off of mutual debts is allowed on insolvency, the creditor is paid. If it is not allowed, then effectively the creditor is not paid. Hence insolvency set-off is creditor-protective. A prohibition is debtor-protective. Very large amounts are involved in markets for foreign exchange, securities, derivatives, commodities and the like, so that the question of whether exposures should be gross or net is a major aspect of legal risk. Set-off is crucially important on insolvency. Set-off is not usually needed if the counterparty is solvent and can pay.

Actually there are three main forms of set-off and netting and the term netting is sometimes used generically to apply loosely to all three forms.

- **Insolvency set-off** of mutual debt claims on insolvency, eg a bank loan against a bank deposit.
- **Close-out netting** which is the cancellation of a series of open executory contracts, eg for the sale of foreign exchange, on default of the counterparty and the set-off of the resulting gains and losses. The procedure is cancel, calculate, set off.
- **Settlement netting** which is the advance set-off of equivalent fungible claims under executory contracts, eg for foreign exchange, when mutual claims fall due for payment or delivery *on the same day*. If one is not able to do this, then counterparties are faced by what is known as the Herstatt risk (after the name of a bank which collapsed in the 1970s) where, for example, a bank has paid its

Japanese yen during the morning when Tokyo is open but the counterparty bank becomes bankrupt before it pays the U.S. dollars in the afternoon when New York opens.

Most countries in the **Anglo-American common law group** allow insolvency set-off and in England it is mandatory.

Most of the **Roman-Germanic group** also allow insolvency set-off, eg Germany, Austria, Netherlands, Switzerland, Turkey, Japan, Korea and Scandinavian countries. But there are some exceptions, eg Slovakia and Russia. As to the **Napoleonic group**, most prohibit insolvency set-off except, for example, Italy. Thus set-off is not generally permitted in France, Spain, Greece, Portugal, most of Latin America (but Panama has insolvency set-off), francophone Africa, and Lebanon, subject sometimes to financial market carve-outs.

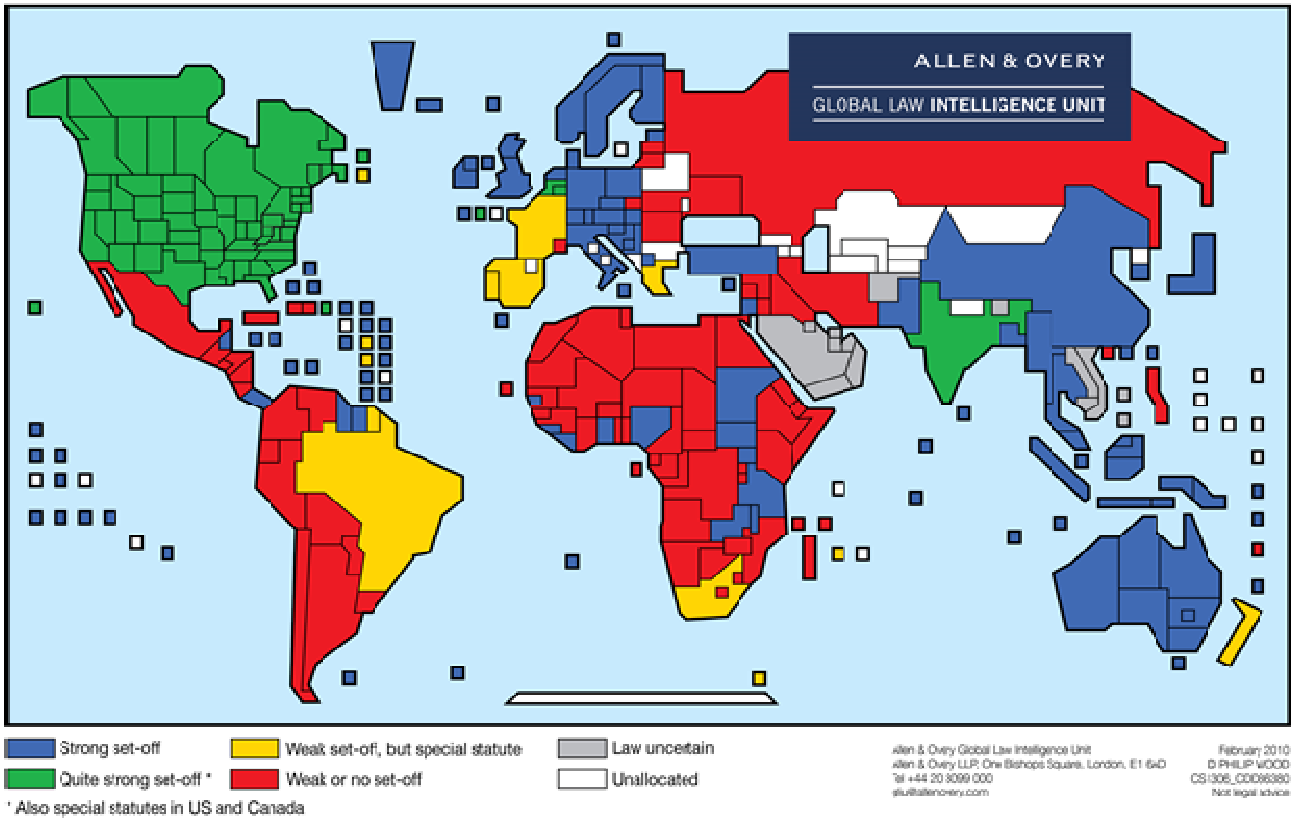
As to **other jurisdictions**, China allows insolvency set-off, but Russia does not. The position in **Islamic jurisdictions**, such as Kuwait and Saudi Arabia, is often unclear. In the case of **transition jurisdictions** a few, such as Albania, allow insolvency set-off, but most do not, eg Belarus, Kazakhstan and Turkmenistan.

This grouping shows why it is important to understand the families of law.

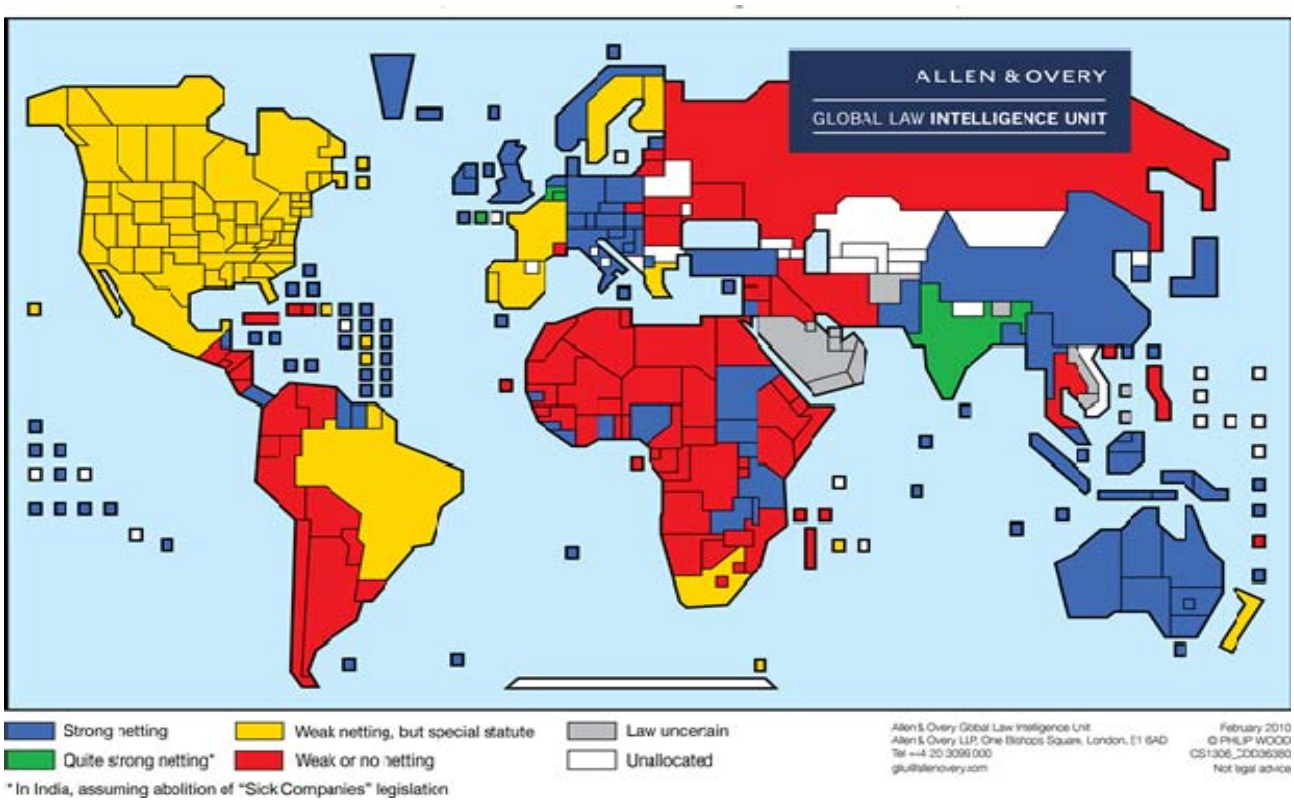
Because of the importance of insolvency set-off and close-out netting, as well as settlement netting, in relation to financial transactions, such as derivatives, foreign exchange and securities markets, as well as deposit markets, the legal risks of not having a set-off are so colossal in terms of the impact on parties if the party they are trading with becomes bankrupt (leading to potentially disastrous domino insolvencies) that many jurisdictions which forbid insolvency set-off have introduced special carve-out statutes. These laws, usually extremely complex, permit set-off in relation to certain prescribed financial transactions where sometimes one or both of the parties is a bank or similar. These carve-out statutes are so prolific that it is almost impossible, even for world experts, to work out exactly what the position is, eg in relation to the branch of a foreign bank within a country otherwise prohibiting set-off.

The worldwide position is demonstrated in two maps, the first entitled "**Insolvency set-off**" and the second entitled "**Close-out netting on insolvency**", both as at around 2006. It is considered that the numerous subsequent changes of detail do not detract from the general message of disharmony.

Insolvency set-off



Close-out netting on insolvency



In the set-off map, red indicates countries which do not permit the remedy. Yellow indicates countries which also do not permit set-off or close-out netting but have a special statute of varying degrees of expanse, permitting it in the case of certain prescribed financial transactions. Green is for countries which have quite a strong set-off, but which for various reasons may be limited or restricted. For example, in the United States there is a freeze on set-off on the commencement of a chapter 11 reorganisation and this would have to be lifted by the courts. In Belgium and Luxembourg, the parties must contract into set-off if it is to be available on bankruptcy. In the blue countries there is a strong set-off or close-out netting, eg because set-off is permitted and because the jurisdiction does not neutralise a bankruptcy termination clause. The colour-coding in the netting map is similar.

Ascertaining what the position is in relation to all of these jurisdictions is difficult. However, in relation to the ISDA master agreement and the Global Master Repurchase Agreement published jointly by ICMA and the Securities Industry and Financial Markets Association, there are legal opinions prepared by local lawyers which cover the main countries. Access is by subscription. Many of these legal opinions are extremely detailed and complex and require considerable time and effort to assess their scope, although this is assisted by summaries and colour-coding.

The position is even more complicated in relation to banks by reason of the new wave of bank resolution statutes which nationalise bankruptcy law, subject to various safeguards, often including safeguards in relation to set-off and netting. Since banks are some of the main players in many markets, these statutes considerably increase counterparty risk.

Apart from checking the availability of set-off and netting under the bankruptcy law of the jurisdiction concerned, it is highly desirable for parties to have a contract to set-off, especially to protect the set-off against assignees and similar interveners, including undisclosed principals, where the counterparty is merely an agent. One also has to be sure that one is checking the right jurisdictions which generally in practice means that one should check all jurisdictions which have a connection with the transaction and the parties, especially the centre of main interests of the counterparty and any branch through which the counterparty may be contracting. The use of a standard form master agreement, such as the ISDA master agreement or the GMRA, is particularly important in reducing legal risks.

Security interests

The second of the super-priority creditors are creditors with a security interest, eg a mortgage or charge or an equivalent title finance transaction such as a repo, financial leasing or retention of title agreement. The purpose of a security interest is protection against insolvency. Security interests are therefore futile if ineffective on the debtor's insolvency. Sometimes they are defensive – a shield, not a sword, as in some project finance transactions.

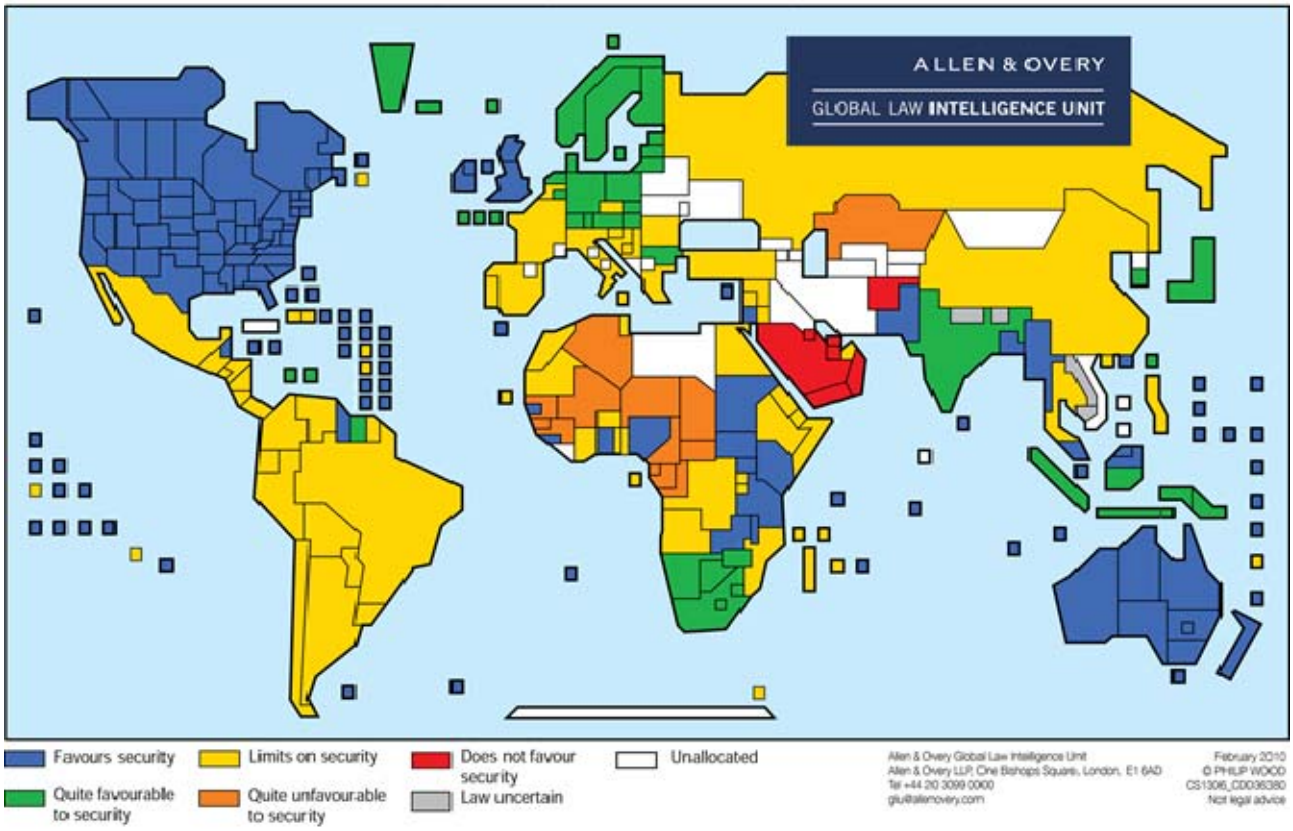
Working out the legal risk of security interests depends on the circumstances. For example, there is a very large sector of special purpose vehicles who borrow secured, eg SPVs for acquisition finance, project finance, property finance, securitisations, and ships and aircraft. The borrowing vehicle is usually a ring-fenced special purpose vehicle so that the shareholders are insulated from the debt and the lenders are insulated from the insolvency of the shareholder. The security package is universal where available. Because the transaction can usually be structured so that the creditors have a substantial control of the vehicle in any case, and because the vehicle does not usually have potential priority creditors who cannot be subordinated by contract, deficiencies in the local security interest regime may not be particularly important. Similarly, in the case of small and medium-sized enterprises, the fact that the company's only lender is a single house bank means that the bargaining power of the house bank can sometimes make up for deficiencies in the legal scope and validity of the security package. The same is sometimes true in relation to home loans.

On the other hand, in financial markets where the collateral is usually cash or near-cash, such as highly rated government bonds, it is absolutely crucial that the security interest should be immediately realisable without any loss of priority to unsecured priority creditors and indeed this situation is supported by special statutes in many jurisdictions such as the financial collateral regulations in the EU.

There is a fundamental diversity between jurisdictions on the approach to security interests, largely because a security interest gives one creditor a priority by voluntary contract, potentially leading to nothing for other creditors, such as trade creditors.

The map "**Global security interests**" is a very broad indication (as at 2006) of jurisdictions which favour security and those which are lukewarm. Blue countries favour security, green countries are quite favourable to security, yellow countries have significant restrictions on security, orange countries are quite unfavourable to security and red countries do not favour a security interest. In countries coloured grey, the law is uncertain.

Global security interests



A very reductionist summary of the general position is as follows:

- **Anglo-American common law jurisdictions** usually favour security. In English-based jurisdictions it is generally possible for a company in two lines to create security super-generically over all present and future assets, to secure all present and future obligations super-generically, to register the charge and that is enough – it is enforceable immediately and informally out-of-court by a receiver managing the assets. The main English-based weakness is subordination of floating assets to certain classes of preferential creditors. In England the law has retreated somewhat from the traditional monopolistic position.

- **Roman-Germanic jurisdictions** are quite favourable.

- **Napoleonic jurisdictions** are often quite restricted in the sense that, for example, they limit the scope of security, notably to exclude future assets and also to exclude bulk receivables and goods. Enforcement often requires court proceedings which can be long and drawn out and for other reasons as well. But there are increasingly wide exceptions in this group.

- **Transition jurisdictions**. These vary. There are wide forms of security interest in Poland, Hungary, Slovakia, the Baltics and other states.

- In the **Islamic jurisdictions**, objections to interest lead to problems. Title finance, such as repos and conditional sales, are often used as a secured loan substitute. This is often called Islamic finance but the title finance transactions are of a very ancient heritage in Western jurisdictions as well, partly in response to old religious objections to usury.

The main criteria in relation to security are (1) the scope of the security, (2) the debt secured, eg whether it can secure future debts or all debts owed super-generically, (3) whether a trustee of the security is available, (4) priority of the security over unsecured preferred creditors, (5) private enforcement through private sale and possessory management through a receiver, (6) no rescue, freezes or other interferences in the security on judicial reorganisation proceedings and (7) low costs.

These and other criteria are shown in a series of colour-coded charts covering "**Security interest in common law jurisdictions**", "**Security interests in Napoleonic jurisdictions**", "**Security interests in Roman-Germanic jurisdictions**" and "**Security interests in transition jurisdictions**". These charts show how important it is that the local regime should be kept simple because of the problems involved in legal risk assessments, eg an assessment of risks flowing from the lack of recognition of a security trustee and the impact that this might have upon the novation of loans in syndicated bank credits where novations are a common technique in transferring the loans. A novation may, in some jurisdictions which do not recognise the trust, cause problems with the continuance of the security interest on a transfer by a lender.

The assets down the left-hand column are:

A. Real property
B. Private company shares
C. Marketable securities
D. Contracts
E. Receivables
F. Bank accounts
G. Intellectual property
H. Equipment
I. Raw materials and inventory

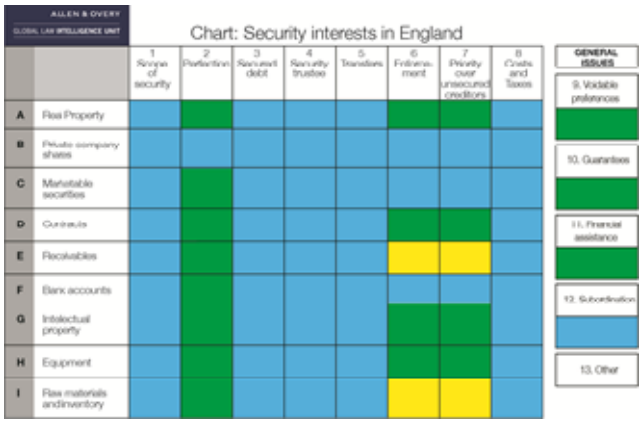
The legal issues across the top and down the right-hand column are:

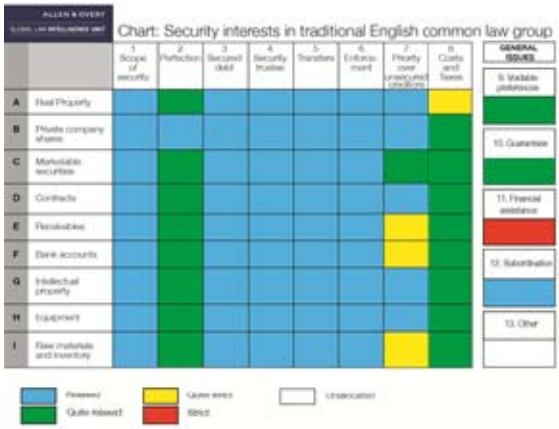
1. Scope of security
2. Perfection (ie registration or other publicity)
3. Secured debt
4. Security trustee
5. Transfers
6. Enforcement
7. Priority over unsecured creditors

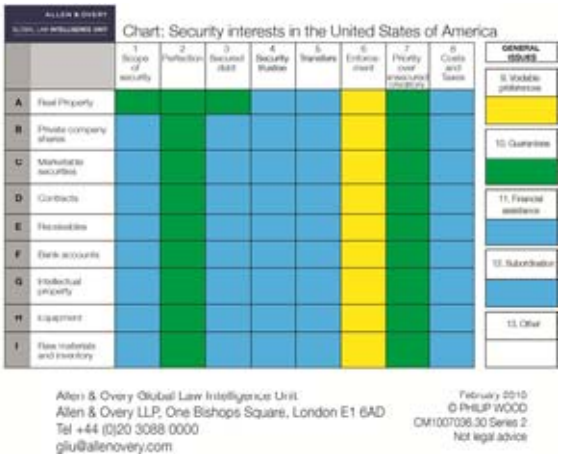
8. Costs and taxes
9. Voidable preferences
10. Guarantees
11. Financial assistance (to buy own shares)
12. Subordination
13. Other

Blue is relaxed or free, green is quite relaxed, yellow is poor and red is restricted. The position is at 2007. The changes since then are not considered major.

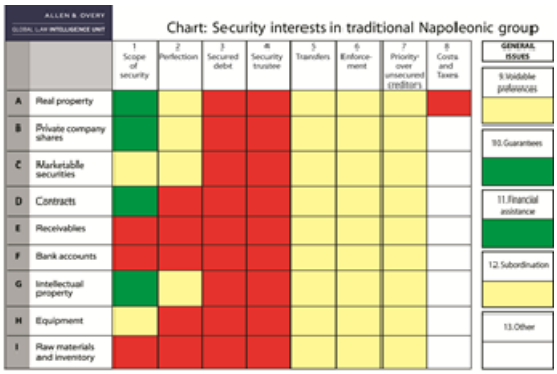
Security interests in common law jurisdictions

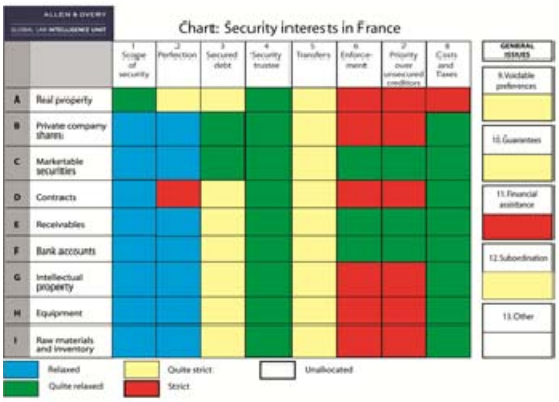


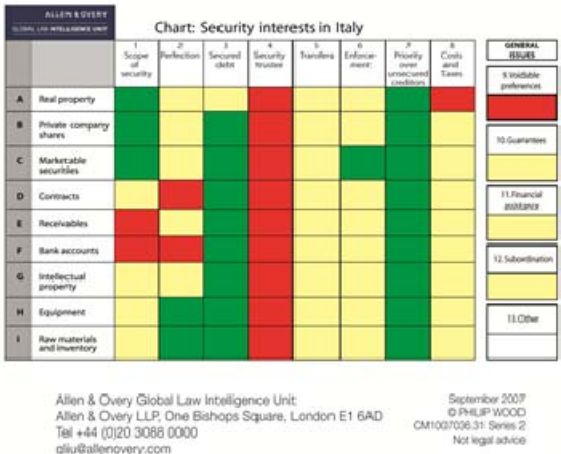


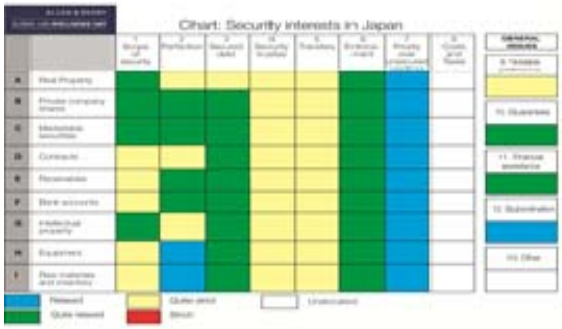


Security interests in Napoleonic jurisdictions

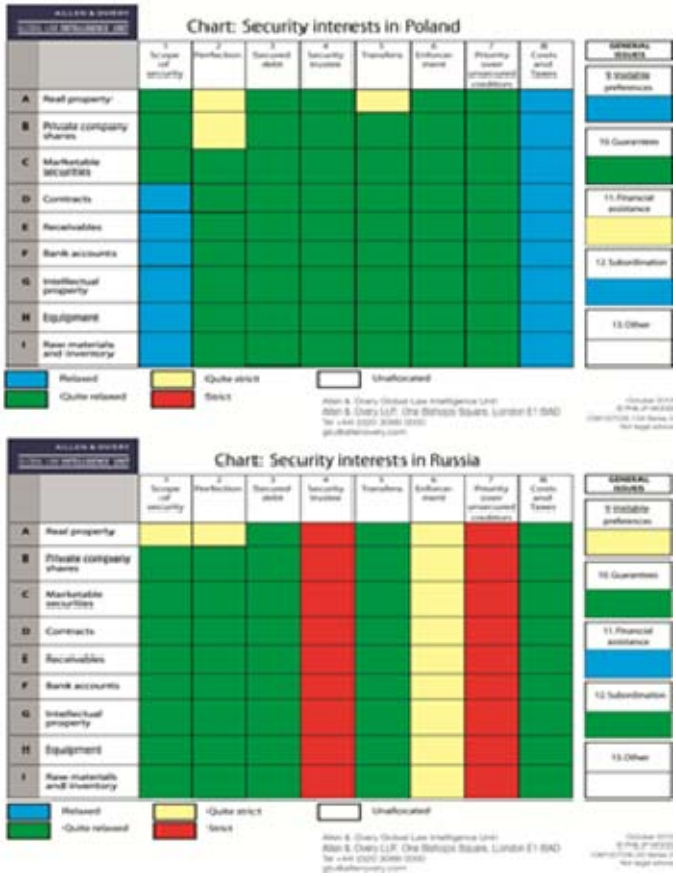








Security interests in transition jurisdictions



Universal trusts

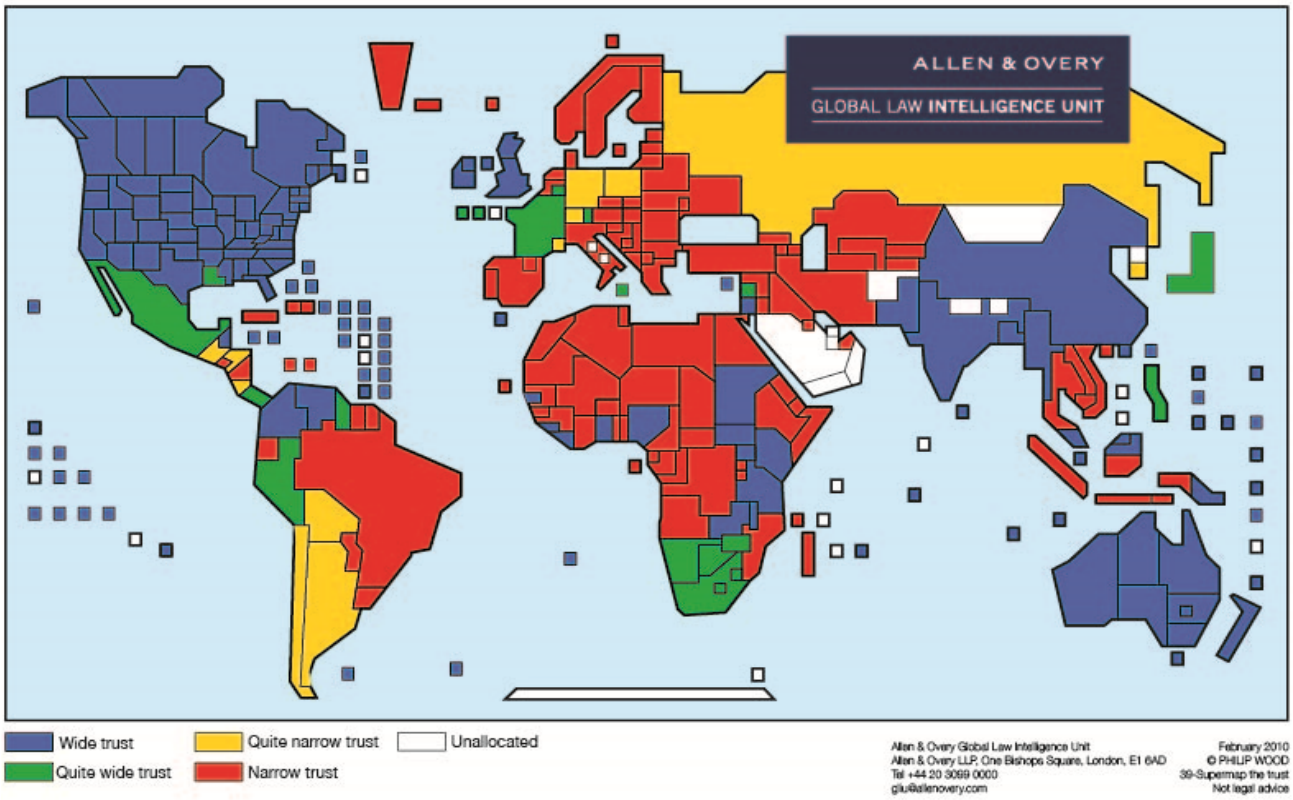
The third super-priority claimant is the beneficiary under the trust. Under a trust, one person, called the trustee, holds title to the assets of another person, called the beneficiary, on terms that, if the trustee becomes insolvent, the assets go to the beneficiary and are not used to pay the trustee's private creditors. The assets are immune and therefore taken away from the debtor-trustee's bankrupt estate.

The main examples of trust are custodianship of securities, pension funds, security settlement systems and trustees of the security for bondholders and syndicate banks. The availability of the trust mitigates the legal risk, for example, of those who place securities in the custodianship of banks and the users of security settlement systems. The amounts involved are truly enormous. For example, the amount of securities held by the Depositary Trust Corporation in New York far exceeds the U.S. GDP. The absence of a trust, especially if there are chains of holders (typical of securities settlement systems and custodianship) creates unexpected legal risk.

All jurisdictions have an effective trust of goods (called bailment or deposit), but only the common law group has a universal trust for all other assets (land and intangible property). Most members of the civil code groups do not have a universal trust, subject to wide exception, especially for custodianship of securities. France does have a universal trust, introduced in 2007 and subsequently extended. There is a universal trust in China and also a trust in such countries as Taiwan, South Korea and Mauritius. Jurisdictions like Jersey and Malta have a trust by statute but this does not generally cover land.

The overall international position is shown (as at 2006) in the map "**The trust**" although this is quite general. For example, many countries have a trust for custodianship of securities, such as Germany and Russia, and so the map is not as bad as it looks for some classes of transactions.

The trust



Nevertheless the unexpected result that assets deposited with somebody as a custodian, such as a nominee of shares, should suddenly and unexpectedly go to pay the trustee's private creditors on the bankruptcy of the trustee is alarming.

Even if there is an effective trust in the case of custodianship of securities, this trust can melt away even in common law jurisdictions, eg if the owner of the securities allows the custodian to use the securities as its own, or by lending them out under stock lending transactions or by using the securities as collateral for private loans. If, for example, a custodian is permitted to use the securities for its own repos and becomes

insolvent while the securities have been transferred to a third party financing the deal, then the real original owner of the securities only has an unsecured claim against the custodian which would often be worthless.

Even if the trustee is protected and a custodian holds securities on an omnibus basis without segregation between clients, then if there is a shortfall for any particular client there may be lengthy delays in resolving the position, as happened in the case of the bankruptcy of Lehmans.

Risk is increased if the assets of several beneficiaries are commingled.

Super-priority creditors and harmonisation

For those who think that a world law is harmonising, you have only got to look at the international treatment of the three super-priority creditors – those with a set-off, secured creditors and beneficiaries under a trust. Compare the position of, say, Russia and China in relation to these super-priority claimants in the relevant maps above. It will be seen that in relation at least to trusts and set-off, China has a completely different position from Russia. The old ancient arguments about these institutions, including the trust which has a very venerable and antique history, have still not been resolved even though the ideas have been around for more than 1,000 years. One would have thought that this would have been enough time to resolve the policies.

Both Russia and China completely overhauled their laws over recent decades after a prolonged period when communism had virtually obliterated their market legal systems so that they had to start again. The fact that, even in the late 20th century, these important countries differed on these issues shows that the world is a long way from consensual legal policy. Hence the cross-border legal risks are accentuated and continued.

Deal invalidity risks on bankruptcy

One of the legal risks of bankruptcy is the invalidation of deals previously thought to be safe and sound. Examples are:

- **Bankruptcy freezes or stays** on payments, deliveries or post-commencement transactions, including in certain cases where the party did not know of the commencement of the insolvency.

- **The revocation of preferences**, including gifts and undervalue transactions, such as guarantees, security granted after the incurrence of unsecured debt, payments in the suspect period, transfers of a business and the giving by a company of financial assistance to buy its own shares, thereby potentially preferring subordinated shareholders over creditors. In most cases, except for deliberate fraudulent preferences, the transaction must be incurred during the suspect period when the debtor is actually insolvent although often this need not be known to the creditor concerned. As to the scope of preferences across the various groups of jurisdictions, see the chart "**Avoidance of preferences**

on insolvency", a very reductionist portrayal of the legal risk of having a payment or other transaction avoided on a subsequent judicial insolvency.

Avoidance of preference on insolvency

		1 ENGLISH LAW	2 NAPOLEONIC	3 ROMAN-GERMANIC	4 AMERICAN COMMON LAW
A	Pauline action (fraud of creditors)	Yes	Yes	Yes	Yes
B	Gift and undervalue transactions – safe harbour	Voidable Usually no safe harbour	Voidable Usually no safe harbour	Voidable Usually no safe harbour	Voidable Usually no safe harbour
C	Preferences (1) – security for pre-existing debt	OK if no debtor intent. Floating charges are voidable	Voidable - no safe harbour	OK if creditor did not know of insolvency or security granted pursuant to obligation	Voidable – no safe harbour
D	Preferences (2) – ordinary course of business payments	OK if no debtor intent	OK if creditor did not know of insolvency	OK if creditor did not know of insolvency	OK
E	Preferences (3) – ordinary preferences	OK if no debtor intent	OK if creditor did not know of insolvency	OK if creditor did not know of insolvency	Voidable - no safe harbour

Strict | Quite relaxed | Quite strict | Relaxed

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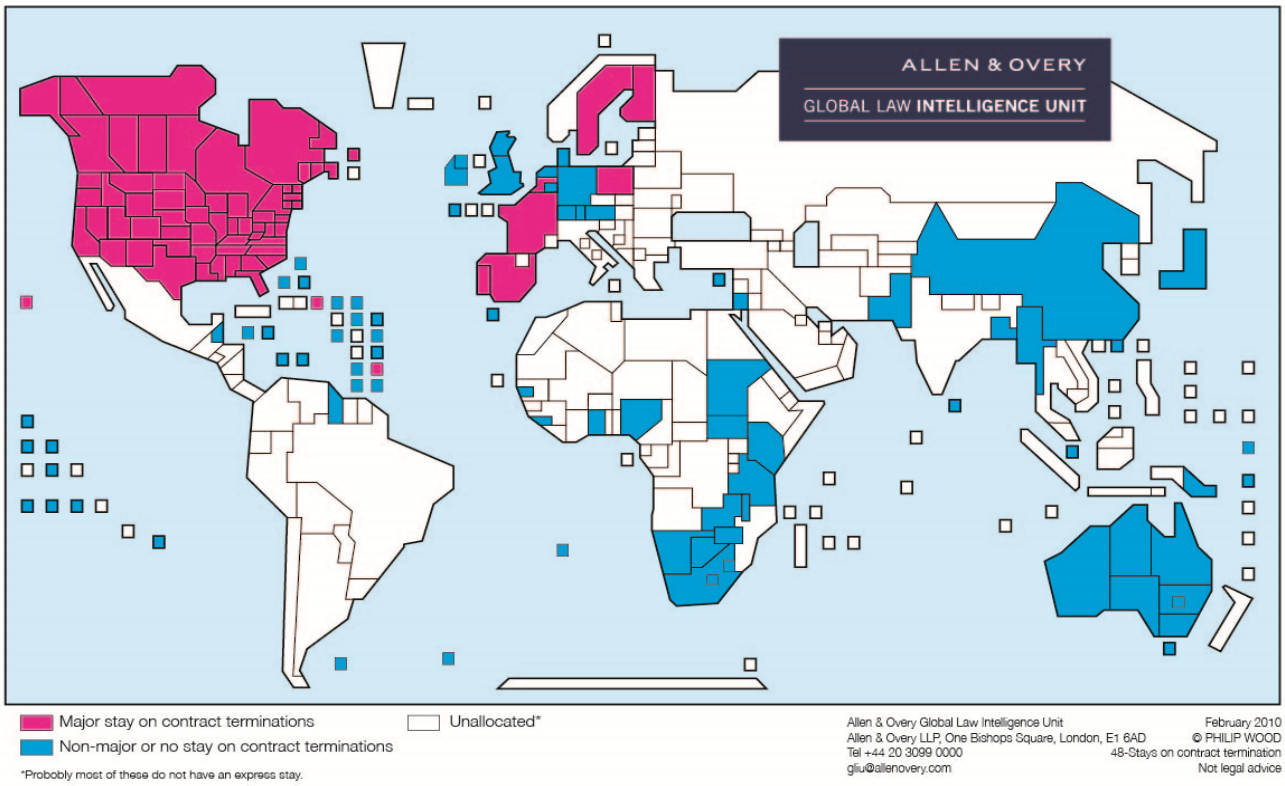
- **Freezes on contract terminations**, which mean that a party has to continue a contract with a bankrupt, subject to various safeguards, a situation which can cause considerable unpredictability. For a non-exhaustive survey of freezes on contract termination as at 2006, see the map "**Stays on contract terminations**" which is, however, by no means complete. The reverse is the destruction of the transaction by virtue of a termination of a contract by the liquidator, leaving the party only with a claim for a dividend. Almost all bankruptcy laws allow liquidators to cancel contracts.

Stays on contract termination



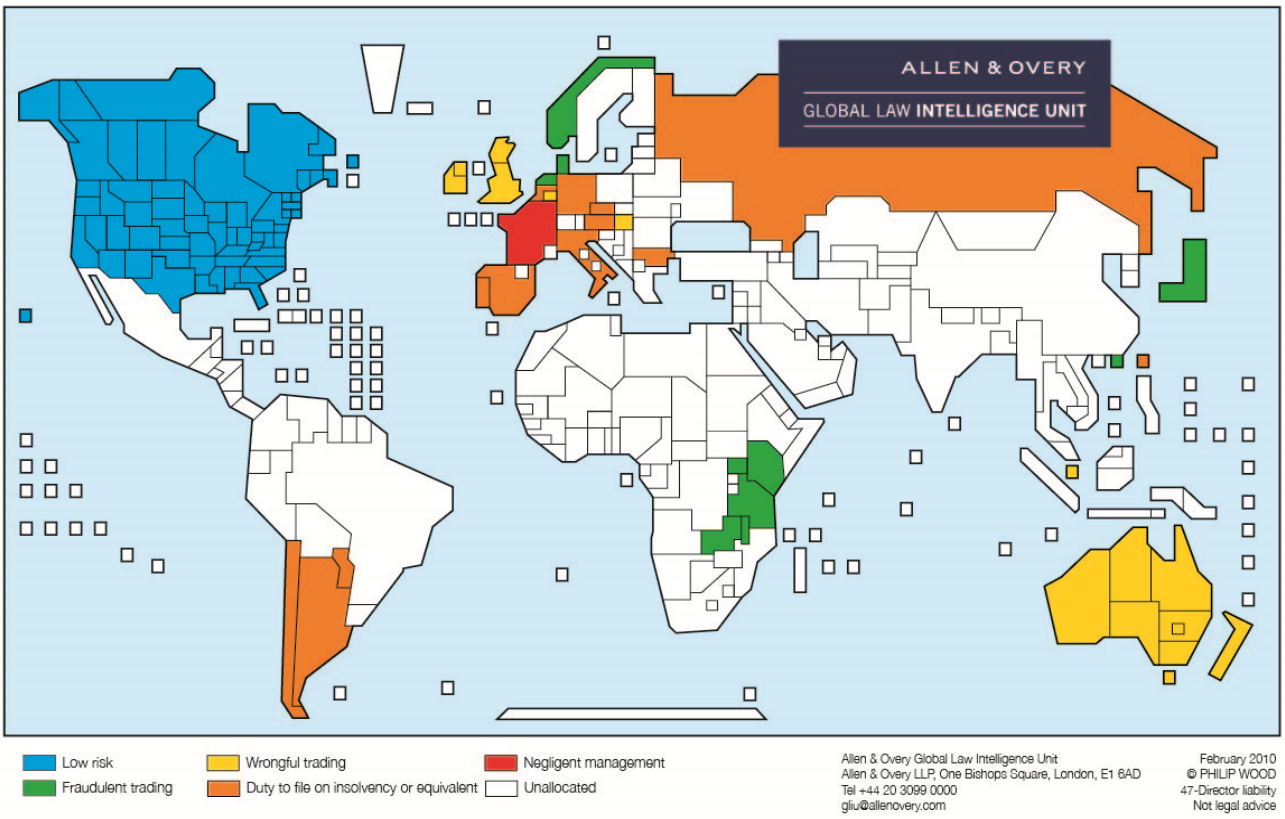
- **Compulsory transfers** which allow an insolvency administrator to transfer contracts, such as derivatives, security agreements and deposits to third parties over the head of the party concerned, so that the party has a new counterparty whose credit it has not previously checked.

Liability risks on bankruptcy

Bankruptcy throws up a number of significant risks of liability, not only lender liability but also liability for management of a bankrupt company or even management of parent companies. Examples are:

- **Director personal liability for deepening an insolvency.** This liability may extend to shadow directors, such as parent companies or individuals who exercise directorial responsibilities, and banks exercising significant influence over the policies of a debtor in trouble. In addition, in many jurisdictions directors are liable if they fail to file for insolvency within a certain period, such as 30 days, after the de facto insolvency of the company – which can include not merely the inability to pay debts as they fall due but balance sheet insolvency, which can be difficult to know in all circumstances because of the problem of valuation.

Director liability for deepening insolvency



See the map "**Director liability for deepening insolvency**", as at 2006. In the blue countries the risk is very low – this includes the United States where the liability of officers for deepening insolvency is virtually unknown. In the green jurisdictions, the liability is also quite low and extends only to fraudulent trading, which is the deliberate incurrence of credit knowing that the company will not be able to pay. In the yellow jurisdictions, the risk is increased because the test there is generally objective failure to take action when the company is drifting into the twilight period. In the orange countries there is a duty to file on insolvency or the equivalent. In the red countries even negligent management may be sufficient.

- **Liability of directors for mismanagement of the company's affairs.** Jurisdictions differ substantially on the degree to which they adhere to the business judgement rule. In the United States the business judgement rule is particularly strong and this is probably true of a great many other jurisdictions as well, but with significant countries of risk, eg France.

- **Breach by a bank of a contract to lend money**, eg because the bank mistakenly thinks it is entitled to rely on "a material adverse change" clause.

- **Abusive credit**, which is lending to a company which is insolvent so as to give a false appearance to other creditors of the company's financial standing. This regrettable doctrine seems to have first surfaced in France by virtue of a French Supreme Court decision in 1976. Subsequently, Austrian

case law imposed liability on state-owned banks which continued to extend loans to insolvent subsidiaries, thereby creating an impression that those subsidiaries were still solvent. Subsequent case law in Austria seems to have rolled the idea back. Fortunately for lenders, the doctrine of abusive credit does not seem to have spread to other jurisdictions.

- **Liability for wrong credit references.** Normally the liability can be countermanded by express exclusions of reliance.

- **Liability of a controller of a debtor**, eg where a bank exercises control through directors appointed to the board by the bank, by intrusive interference in management, economic coercion, control via pledged stock, or the use of a clause allowing a lender to approve or veto management. Jurisdictions differ on the extent of interference or dominance necessary to satisfy the control criteria. Heads of potential liability include:

  - The bank or the parent company is liable as a manager or is a shadow or de facto director, thereby incurring personal liability for wrongful or fraudulent trading.

  - The bank or corporation or parent is liable by contract to indemnify a nominee on the board who incurs personal liability as a director.

  - The bank or corporation deliberately procured a known breach of contract by the debtor, eg on loan or supply contracts.

  - The loan of the bank or associated company is equitably subordinated, as where the bank or associated company exercises dominant interference over the debtor's management and thereby causes loss – this appears to be an exclusively U.S. doctrine.

  - The bank or associated company is an insider or connected person under preference law, leading to revocation of transactions on the insolvency of the counterparty even if the party did not know of the insolvency.

  - The bank or associated company controls the company and is liable as a controlling person under U.S. federal securities laws, eg under a prospectus in certain circumstances.

- **Liabilities of a secured creditor.** A secured creditor may incur liability under the following heads, for example:

  - Enforcement when the creditor is not entitled to enforce, eg because of a misinterpretation of an event of default.

  - Failure to obtain a reasonable price on a sale.

- Liability as a mortgagee in possession or via receiver in English-based countries, especially for ships, aircraft or for tort liability.
- Misrepresentation to purchasers as to the value of the assets.
- Environmental liability.

- **Liability for pollution under environmental legislation.**

Strong-arm bank resolution statutes

The financial crisis of 2007/2008 gave rise to a considerable number of new risks for banks and corporations. One of the most striking of these new risks arises from strong-arm bank resolution statutes which effectively nationalise bankruptcy law in the case of banks in financial difficulty. The intention was to have emergency legislation in place which would enable the authorities to deal with banks quickly and effectively so as to prevent a systemic crisis. These strong-arm statutes have very significant consequences beyond the prevention of systemic collapses of a banking system.

Apart from general powers to nationalise banks or to make forcible transfers of bank shares or to take over the management of banks, regulators typically have the ability to transfer assets and liabilities separately so that there could be a cherry-picking of assets or liabilities. One of the main objectives is to be able to transfer deposit liabilities to a new bridge bank so as to protect individual depositors. Indeed, much of the legislation is intended to safeguard depositors against the risks of a bank insolvency, as opposed to senior bondholders. This is also a feature of regulatory rules to prevent proprietary trading by banks, to switch derivatives to clearing systems and to ring-fence commercial banking from investment banking. The individual depositor (who has a vote) is the darling of the legislature.

In addition, a few of the new statutes allow the authorities forcibly to convert senior bondholders and other creditors into shares or to write down their claims, commonly called "bail-in". Again, the main object is to protect depositors.

The first statute of this type appeared in 1933 in the United States and was subsequently borrowed in one form or another by a few countries, such as Canada and Japan. The statutes really took off from around 2009.

These statutes pose three main questions in relation to the assessment of counterparty legal risk:

- How does one do a credit analysis of a bank if assets can be cherry-picked and separated from liabilities?

- How can one effectively carry out a resolution of an international bank with branches in many countries if each country has more or less arbitrary powers over banks and branches within its own jurisdiction? International comity requires rules rather than national self-protection and the protection of national creditors such as depositors. It seems quite likely that countries will seek to protect their own national creditors and depositors so that the nationalistic free-for-all could worsen the conflicts in the case of an international bank.

- How can predictability be protected if the authorities have arbitrary powers on a bankruptcy? These statutes undermine the certainty that the law in this area requires.

Bankruptcy legal risks as key legal indicators

The fact is that bankruptcy is the prime source of key legal risk indicators. Most of the topics covered in the above list affect both banks and ordinary corporations and increase their international legal risks.

For banks there is no question that the availability of the three super-priority claims are key legal indicators, as are freezes on the termination of contracts (which interferes with close-out netting), fraudulent preferences, the loss of priority risk arising from post-commencement new money, and the recognition of a foreign insolvency.

In the case of corporations, there are bankruptcy risks of personal liability in those jurisdictions which impose personal liability on directors for deepening insolvency. There is also the risk of criminal liability if a company gives financial assistance to buy its own shares. The typical example would be where a bidder finances the acquisition of a target company by a loan and after the takeover arranges for the target to guarantee the loan and charge its assets to secure the guarantee. The commercial effect is similar to the repayment of the share capital of the target before its creditors are paid. Shareholders should be subordinated to creditors.

The Delaware regime does not prohibit financial assistance and so is free on this point. The traditional English regime has a wide prohibition – not just England any more. Most Roman-Germanic regimes are against it, with Napoleonic regimes hesitant. The EU has a prohibition against financial assistance by public companies. Some countries allow financial assistance by private companies (not public companies) if solvency is established. A contravening transaction is usually a criminal offence and void, thereby exacerbating legal risk.

Other important indicators for ordinary corporations are corporate governance (difficult to measure), and, to a lesser extent, minority protections. Substantive consolidation on insolvency is a risk but is usually quite rare.

Corporations and their management have considerable risks in relation to offering circulars and financial statements.

Extraterritorial insolvency jurisdiction

In most countries the jurisdiction to commence insolvency proceedings is often exorbitant and is typically based on the presence of local assets, such as a single bank account. Since jurisdictions generally apply their own law to local insolvency proceedings, the effect is that a foreign business can be subjected to an adverse local insolvency law, such as the personal liability of directors or the setting aside of preferences, quite unexpectedly.

There are a few (very few) international conventions. There is a basic common regime in the European Union where proceedings must be opened at the debtor's principal place of business or centre of main interests, with the addition of the place where the debtor has an establishment. Typically, local law then applies, subject to exceptions. But even here, the centre of main interests of a corporation can be moved from its previous location as at the time of the particular transaction. A number of countries have adopted the Uncitral Model Law on cross-border insolvency, but this is far from being a complete code.

Mitigating bankruptcy risks

The management of bankruptcy risk is probably one of the most highly developed and sophisticated disciplines of all legal disciples, outside basic criminal and constitutional laws. The techniques range from credit analysis, sovereign risk analysis, and the use of credit reference agencies and the like, through to some highly refined mitigants such as moving the centre of main operations of a company from a jurisdiction with unfavourable bankruptcy laws to a jurisdiction which is protective of the debtor or creditors.

Practically every clause in a syndicated loan agreement is concerned with the bankruptcy risk. For example, a negative pledge is mainly designed to prevent the borrower from subordinating the unsecured lender to a secured creditor on bankruptcy. The ubiquitous cross-default is designed as an early warning of bankruptcy or competition between creditors. The use of central counterparties in securities, commodities and derivatives markets is designed to mutualise trades so that, on the bankruptcy of a counterparty, all the trades can be netted or set off so as to reduce the exposures. If central counterparties were not available there would be much greater bankruptcy risk, with accompanying risk of cascade or domino insolvencies, than there is already. On the other hand, they lead to a huge concentration of risk.

There are other measures which can be taken to reduce bankruptcy risks, measures which are currently being developed to meet the rapidly changing bankruptcy legal environment in the world.

This topic will be addressed in more detail in a later version of this paper.

Chapter 10

Regulatory legal risks

Why regulation is different from the ordinary law

Regulatory law differs from ordinary law for three main reasons:

- A **governmental regulator** which is an agent or arm of government, is at the same time the legislator in the sense that it makes rules, the executive, in the sense that it monitors compliance with the rules, and a judicial tribunal to punish offences. In other words, many regulatory bodies run contrary to basic constitutional notions of the separation of powers and involve a concentration of power in a single governmental body. For example, in the case of enforcement, the regulator may be acting as both prosecutor and judge in its own cause, a conflicting role which would not be permitted under the ordinary criminal law.

- The rules are usually extremely **detailed**, prescriptive, intricate and subject to rapid change. By virtue of the legislative power of many regulators, with or without central government control, they tend to use their delegated rule-making powers to the full, so that many regulatory codes are enormous in size and disproportionate.

- The law is **criminalised** in the sense that people can be disqualified from practising their professions in the case of certain violations and offending firms can be faced with very substantial fines. Notwithstanding the criminal nature of the sanctions, the subjects of the law often do not have the protections of the criminal law, such as the right to silence or the burden of proof beyond reasonable doubt.

The classes of regulation are numerous and widespread. Everywhere one looks, there is a set of regulations enforced by a regulatory authority. Taken to extremes, regulation can be a form of legal oppression, in particular where regulators do not recognise that the above challenges to basic rule of law principles applicable to governmental authorities require that they exercise their powers with restraint. Regulation is a considerable source of legal risk for banks and ordinary corporations in their daily operation.

Mitigation of regulatory risks

Again, specific methods of risk mitigation will be considered in a subsequent edition of this paper. The techniques of covering such a vast field are numerous, and the practice is on the move.

Risks of financial regulation

Financial regulation is vast and intrusive. It multiplied rapidly after the financial crisis of 2007/2008.

It is remarkable that the huge volume of financial regulation prior to the financial crisis is being repeated, post-crisis, even though the previous regulation demonstrably did not work. Much of the new regulation, apart from the increase in required capital and certain others seem irrelevant or of marginal significance. This is underlined by the fact that, prior to the financial crisis, you only had to know one simple fact, ie that there was a bubble in house prices. You could hardly have had a simpler loan than a home loan and you could have hardly had a simpler cause of financial collapse than a bubble. There was nothing esoteric or arcane or complex or foxy about home loans and bubbles. Virtually everybody – central banks, regulators, governments and the public – cheered on the merry-go-round and congratulated themselves on their good fortune. It is therefore hard to understand why policymakers should think that this astonishingly elementary mistake by entire societies should merit anything more than a two-liner: "Watch out next time".

It is almost as if the legislature decided to use the opportunity to shoot on sight everybody that they did not like so that we have a sort of wild outbreak of random lawlessness as old scores are settled. People were indignant and full of rage about what happened. The statute book is not the place to rant and rave. The statute book is a holy thing.

One may list some of the potential sources of legal risk introduced by financial regulation:

- **Unauthorised business** ie a bank carries out a business which it is not technically authorised to carry out, eg in a foreign territory, or sells a product which is not technically authorised to sell. In each country with any form of financial regulation, the definitions of what is permitted and what is not permitted are extremely complex and intricate. It is difficult for international banks to carry on business on a cross-border basis and at the same time be sure that they are in compliance with local authorisations. If banks are split up and ring-fenced so that banks taking deposits are permitted only to make ordinary loans while all other forms of banking must be dealt with by another company in the group, then there are likely to be endless additional risks caused by the indeterminacy of the shifting boundaries between the classes of banking.

- **Misselling**, ie selling a product to a consumer which is unsuitable or too complicated. Consumers often think that the bank is advising them. It sometimes is not apparent to them that banks sell things, like anybody else, and therefore that, if they do not understand the product, they have to get advice. In practice, banks often have a duty not to sell unsuitable products to consumers.

- **Violations of conduct of business rules**, ie a violation of duties of skill and care, especially duties owed to unsophisticated investors, risk warnings, front-running, timely execution, proper allocations,

avoidance of conflicts of interest, rules about promotion and advertising, the keeping of records, reporting, and the segregation of client assets so that they are held in trust.

- **Prospectus liability**, including the liability of arrangers or underwriters for negligent mis-statements made by the issuer. There is underwriter negligence liability for public prospectuses in the United States, Brazil, China, South Korea, Japan, Singapore and Australia, amongst others. Liability for negligence is greatly different from a liability for actual fraud, ie knowing or reckless misrepresentation or omissions in a public prospectus. Liability for fraud is incurred everywhere. Mitigating the risk of negligence liability requires the exercise of considerable investigative due diligence.

- **Liability for market abuse and frauds** eg wash sales, price positioning, corners, false rumours, puffing (pumping and dumping), scalping (as where a journalist puffs a security which the journalist has previously bought), market timing, churning (this is rolling over purchases and sales of securities frequently so as to generate commissions), short-selling (this is selling a security which one does not initially own), false markets, market manipulation, insider dealing and misleading behaviour. Some of these market frauds and forms of market abuse can be difficult to distinguish from legitimate transactions and can be extremely technical. It is a fundamental rule of law principle that the law is clear and accessible to the layman.

- **Infringement of capital and liquidity rules or large exposures**.

- **Proprietary trading** Infringement of rules, such as the U.S. Volcker rule, preventing proprietary trading by banks or establishing the ring-fencing of banks.

- **The incurrence of liabilities for securitisations**. Post-financial crisis regulations make securitisations much more difficult because (1) it is more difficult for a securitisation to qualify for off-balance sheet treatment under accounting and regulatory rules, (2) more capital is needed, (3) there are requirements that those organising the deal must retain some of it, such as 5% ("skin in the game"), (4) capital charges on resecuritisations, (5) much more mandatory due diligence and disclosure and less reliance on credit reference agencies, and (6) lower capital eligibility of securitisation notes for collateral.

- Violation of rules regarding the carrying out of **derivatives** through an affiliate and clearing them through central counterparties. There are extensive rules both in the U.S. and the EU to this effect.

- The infringement of the regulatory regime applying to **hedge funds and private equity funds**, in both the U.S. and the EU. In the EU a directive of 2011 requires the managers or advisers of hedge funds and private equity funds to be authorised. There are restrictions on delegation, a need for professional indemnity insurance, valuations, restrictions on remuneration, conduct of business rules,

requirements for the management of risk and liquidity, restrictions on eligible depositories, maximum leverage and other matters. The rules were due to come into force in stages.

In the U.S., certain **whistle-blowers** or informants are granted huge mandatory rewards of 10% to 30% of the penalties – often millions. It is inconsistent with the rule of law to encourage perjury and false witness.

Other areas of regulation

Altogether developed countries have about 30 areas of major regulation, sprawling across and choking the ordinary laws. Outside tax and customs duties and outside financial regulation, other major areas of regulation typically include the following:

- **Anti-money laundering laws**, eg reporting of suspicious transactions. Anti-money laundering reporting was originally aimed at drug trafficking, although it was also designed to track other crimes and terrorism. Banks are commanded to be the principal detectives since they handle money. The effect of much of the legislation is that banks which fail to detect the proceeds of crime are treated as aiding and abetting the crime, at least in the public mind, although there is no criminal intent or the protections available to an accused under the criminal law. The national regimes normally involve high risks for banks, and burdensome procedures for them and large sections of the population.

- **Consumer credit**

- **Product liability**

- **Food and drug regulation**

- **Health and safety regulation**

- **Building regulations**

- **Data protection, confidentiality and privacy** Data protection legislation in the European Economic Area is all-embracing: pretty much everything about a living individual and processed electronically is caught. The U.S. regime is less protective. Data transfer agreements may be necessary. Prosecutions are not frequent, but compliance with requests for access can be onerous, time-consuming and expensive.

- **Regulation of professions and trades**

- **Transportation regulation**

- **Employee protections**, eg hiring and firing, minimum hours, minimum pay, maternity leave, redundancy and dismissal, harassment and discrimination.

- **Pension regulation** The liability risks for pension trustees and company sponsors are particularly high. The tasks are generally delegated to fund managers and the like so that trustees are to a large extent concerned with supervising and monitoring the experts. The combination of demography and low interest rates has hit returns and hence sharpened the exposure of trustees and put pressure on companies to fund pension liabilities.

- **Specific protections for individuals**, eg laws limiting exclusions of contract liability, laws limiting jurisdiction in litigation to the domicile of an individual defendant, protective security interests, and the local governing law of employment contracts.

- **Antitrust and competition laws**

- **Restrictions on foreign direct investment**

- **Controls on state aid** (in the EU)

- **Exchange controls interfering with payments** Exchange controls are mainly a feature of emerging countries. They may also be introduced temporarily by insolvent states. Exchange control regimes tend to be volatile and discretionary. The introduction of exchange controls after a transaction is signed is a typical risk sought to be dealt with by mitigants often relevant to project finance, eg bilateral investment treaties, clauses in host government concessions, and official insurance, such as from export credit agencies.

- **Environmental regulation**

- **Real estate development controls and zoning**

- **Regulation of natural resources**

- **Sanctions and embargoes** These laws typically prohibit dealings with specific individuals and entities or residents of a hostile country. The prohibition may be limited to trade in specific products. Banks are particularly exposed because they may receive the proceeds of an illegal transaction where it is alleged that there were red flags. Tracking beneficial ownership of money transfers, foreign exchange and securities can be problematic. International databases listing prohibited individuals and dealings are available. U.S. sanctions are generally tougher than EU sanctions which in turn are generally tougher than those of the UN. There are currently sanctions against Iran, North Korea and Afghanistan, amongst others. Since sanctions are directed at the enemy, enforcement can be ferocious.

- **Immigration** Companies may be liable for employing illegal workers.

- **Corporate governance codes and listing rules** The taking on of a directorship of a company, particularly a listed company, is not something to be done lightly. The regime in many countries heaps duties and liabilities on senior management to a fearsome degree. The risks are at their most perilous when a company is in financial difficulties or in the twilight of impending insolvency. Otherwise, particular areas of risk include (1) general duties of diligent management (especially in relation to new ventures, financing, and acquisitions), (2) insider dealing and (3) financial statements. The liabilities of the senior management of banks under regulatory regimes is extremely burdensome by reason of concepts of ultimate responsibility for supervision, regardless of personal knowledge.

- **Shareholding disclosure duties** The rules require the disclosure of, amongst other things, beneficial ownership of traded share voting rights of between 3% and 5% and upwards, with more sensitive thresholds during takeovers. Because the rules can catch contingent or shadow interests, such as convertibles, options, derivative exposures, repos, security interests and stocklending, the regimes internationally are exceptionally complicated. Recent cases of alleged violating non-disclosure have attracted enormous public opprobrium, as though breach was a major criminal fraud.

- **Financial reporting and disclosure rules**

- **Landlord and tenant regulation**

- **Alien ownership of land**

More detail about these heads will be set out in a later version of this paper.

The case of Mr Iguchi

Actions by regulators against regulated institutions can be unpleasant. An example is the unfortunate case of Mr Iguchi.

In the 1990s Mr Iguchi was a trader at the New York office of the Japanese bank Daiwa which was then the 19th largest bank in the world. He allegedly lost $1.1 billion trading U.S. Treasuries. When found out, management did not report the losses to the U.S. regulators for two months. Daiwa said it had been advised by the Japanese regulators that disclosure would have an adverse affect on the Japanese banking system which was then in trouble. The U.S. regulators peremptorily closed down Daiwa in New York. Daiwa settled for a fine of $340 million. Mr Iguchi was jailed for four years and fined $2.6 million – quite a lot for a salary man. Later a Japanese court ordered executives and former executives of Daiwa personally to pay

fines of $775 million for the losses caused by the New York branch management, just to show that if the U.S. was tough, Japan was even tougher.

Legal risks from taxation

Of all the bodies of law, taxation is one of the largest and arguably the most complex. Filling in a national tax form by a small business is beyond the reach of the layman and experts have to be employed. This is so notwithstanding the fact that, of all arenas of law, tax is most readily available on the internet and in other publications. Internationally, the management of the tax affairs of multinational companies requires armies of both internal and external experts. The accurate application of tax to a major transaction spanning many jurisdictions is beyond ordinary comprehension. Tax codes can be so unintelligible that even experts cannot figure it out and have to say "dunno". The situation is worsened by tax extraterritoriality and by the near-universal tendency for tax law to look through to overall commercial effect as opposed to the strict letter of the law.

Against this bewildering background, one can only suggest a few rules of thumb for risk mitigation, apart from the employment of experts for practically everything one does.

- Banks and corporates have to be concerned with their tax reputation, not just with legality. Even if a business engages in legitimate tax planning so as to reduce the tax burden in the interests of creditors and shareholders, there may be a public outrage at tax avoidance, however legitimate the avoidance. Tax issues are in the public domain.

- An increasing number of tax codes rely on general anti-avoidance rules which look at substance over form and give rise to a tax charge in cases where, by the letter of the law, no tax would be payable. These general anti-avoidance rules create a cloud of uncertainty which arguably undermines the rule of law.

- If an independent expert offers a tax scheme, then even if the selling expert is a reputable firm, the scheme should be checked independently in case it is risky. Experts are selling something and, just as you would not buy a house without having it surveyed, so you would not have an important scheme implemented without independent analysis first.

- A transaction whose sole or main purpose is to avoid tax and which is otherwise artificial should be viewed with caution. A transaction which has no commercial purpose or rationale may be suspect and thereby increase risk.

Regulatory enforcement risks

Regulatory statutes provide for both criminal and civil sanctions.

Typical offences include doing business without official authorisation or licence, making a public offer of securities without a compliant prospectus, communicating an unlawful financial promotion or failing to notify a large shareholding in a bank. They include mis-statements, eg wrong statements in a prospectus or financial statements or fibbing to the regulator. They include market frauds, such as market manipulation or insider trading.

In the U.S. the Racketeer Influenced Corrupt Organisations Act is often used in plaintiff litigation, largely as a way of menacing the defendant and also because it allows for treble damages in a private action for securities fraud. RICO was initially intended to curb organised crime but it is framed in such broad language that it is frequently used to cover securities frauds or allegations of fraud.

The criminal sanctions can include fines and imprisonment. The penalties can be severe. In 2005 Mr Ebbers, the chief executive of WorldCom, which became the world's largest corporate bankruptcy until then ($100 billion), was sentenced to jail for 25 years for false financial statements in a prospectus.

A criminal prosecution will sometimes damage the firm so greatly that it is unable to pay compensation to victims or to continue in business. An example is the demise of the accounting firm Arthur Andersen in the early 2000s for allegedly deliberately destroying evidence in relation to the failed firm Enron – a conviction subsequently overruled by the U.S. Supreme Court. By then the damage had been done.

Violations of the regulatory regime are typically backed by administrative sanctions, initiated by the regulator, which fall in a no-man's land between civil and criminal liability. The reasons that regulators can bring the action instead of the private citizen include the fact that the regulator often has greater resources and information-gathering powers and has a duty to police the market. The disadvantages are that the regulators may have excessive powers and there is often a dismantling of criminal protections.

Administrative contraventions typically exclude a breach of fiduciary duties, for example, conflicts of interest, a breach of a duty to maintain regulatory records, a breach of market conduct standards, a breach of authorisation conditions or a violation of the rule to have proper systems and controls – a somewhat vague allegation.

Administrative sanctions typically include public censure, unlimited fines (sometimes extremely large), revocation of a licence to do business (the ultimate nuclear weapon), injunctions to restrain wrongful conduct, asset freezes, interventions in management, orders for the disgorge of profits and restitutional compensation to victims, and disqualification of managers, auditors or actuaries – they lose their right to work in their profession, either for a period or permanently.

In the U.S. there are restraints on the powers of enforcement by regulators but nevertheless regulatory action can be aggressive.

Typical regulatory powers in many countries include on-site inspections, duties of the firm to provide information that the regulator should know about, even if not requested, investigations by outside investigators and experts, search and seize dawn raids and whistle-blowing, eg by auditors.

It is obvious that the sanctions are as tough, if not tougher, than the criminal law, except for jail. The main problem for administrative remedies is (1) that often they are not accompanied by the protections available in the criminal law and (2) they semi-criminalise conduct which would normally be regarded as attracting civil liability only, eg conflicts of interest, failure to deliver best execution, unsuitable investment.

Examples of criminal protections which are sometimes ignored include:

- The right to a trial by an independent and impartial tribunal and not by a regulator who is investigator, prosecutor, judge and jury in its own cause.
- The right to trial by a lay jury.
- Clarity of the offence, not some vague principle.
- Presumption that the legislation should be construed in the defendant's favour if there is ambiguity (the rule of lenity).
- Presumption of innocence until proved guilty.
- Proof of guilt beyond reasonable doubt as opposed to a balance of probabilities.
- The privilege against self-incrimination and the right to silence.
- Strict rules of evidence.
- The exclusion of evidence of previous offences.
- The need to prove dishonest criminal intent or recklessness, not just negligence or lack of supervision.
- No necessary right to a speedy trial if it is a civil case.
- Secret settlements made under threat undermine the principle that justice should be open.
- Fines are calibrated to wealth, which is inconsistent with the criminal law rule that the convicted are treated equally, rich or poor.

There can also be issues as to whether a violating contract or other transaction is void.

There may be also private rights of action against injured investors which include the adversities discussed in chapter 13 on litigation risks.

In the U.S. the use by prosecutors of threats has been criticised – because of the very adverse effects of a public allegation of "fraud" (which can destroy a firm), the criminalisation of commercial law, and prosecution in the court of public opinion without due legal process (judge, jury and executioner).

An illustrative composite case is where a regulator alleges that a large international bank has violated a U.S. criminal or regulatory law. The complaint is framed in colourful language and makes many allegations of members of the bank engaging in criminal activity, whilst senior managers turn a blind eye. The bank is made to appear a criminal organisation. If the regulator claims a breach of sanctions, then the allegation is that senior management was conspiring with terrorists. If the violation is said to be money-laundering, then it is made to appear that the bank itself is fraudulent, even though the bank is only a detective. If can cost billions to be a bad detective.

The share price of the bank falls sharply which results in immediate losses to pension funds that hold the shares. The regulator threatens to revoke the licence of the bank. This would be disastrous for an international bank carrying out business in New York because all international banks must be able to participate in the U.S. dollar payment system, amongst other things. If the trial is prolonged, the unresolved claims of criminality are likely to deter customers and depositors of the bank, especially if the bank is foreign. The bank may very well have a defence but the threats to the licence and the prejudicial impact of a continuing claim against the bank damaging its reputation lead the bank to settle.

The bank subsequently pays a large sum of several hundred millions or even a few billion to the regulator. The public hears the prosecution but not the defence. If the rule of law gets a bruising, too bad, there are bigger issues at stake.

Mitigating regulatory risks

It is not easy to set out general rules for mitigating risks arising from the two dozen or so regulatory fields which impinge on banks and ordinary businesses and this too must be left until a later version of this work.

All one can say at present is that there is heavy reliance on the appointment of internal experts who deal with compliance and on staff training and manuals. There is heavy reliance on supervisors of supervisors of supervisors. Major problems are the fact that even the experts can struggle to cope and that, except for very obvious fields, such as not paying large bribes to public officials, if is often hard for ordinary members of staff and executives to learn and recall all the detail. In many cases this is just not feasible. In addition, particularly in the field of financial regulation the precise boundary of the criminal law is often unpredictable.

Chapter 11

Extraterritorial legal risks

Introduction

Now that the seven billion people of the world are so tightly squeezed together, their laws burst the river banks of their boundaries into other countries. Laws barge outside sovereign states as each national sovereign state elbows its way through the crowd.

The result is that people from one jurisdiction can find themselves arrested or brought before a court in another jurisdiction quite unexpectedly. They can be subject to laws which are completely different from the laws of their own state. They can find themselves subjected to the payment of huge damages claims or fines, obliged to provide all documents and emails to a hostile party in litigation, barred from doing business, or extradited to answer criminal charges in a foreign country.

Firms can also be compelled by the law of one country to do something which is a criminal offence in its own country, such as disclosing confidential documents.

The territorial trespass is not an intrusion on sovereignty if all or most societies agree on the policy. For example, it is hard to disagree that the payment of bribes to public officials is or should be a universal legal policy so that extraterritoriality should not be an issue in that case. The problem arises if societies legitimately do not agree on the general policy of some other law or do not agree on the degree of criminal protections of the accused or do not agree on the proportionality of penalties or the like.

Notwithstanding that some laws may indeed represent a reasonable consensus or are justifiable, the presence of increasing extraterritoriality can increase tensions between nations and lead to distrust and resentment.

A simple example

A simple example is where a bank in Beijing sells a U.S. dollar bond to a bank in Hong Kong.

- The sale may infringe the U.S. financial regulation prohibiting the Hong Kong bank from engaging in **proprietary trading** (the Volcker Rule, when it comes into force) if the Hong Kong bank has a branch or subsidiary in the U.S. and perhaps if the transfer involves the dollar clearing system in New York or a transfer at the Depository Trust Corporation or if the Hong Kong bank is buying for a fund which includes U.S. residents or if somebody in the U.S. worked on the transaction.

- The sale may infringe U.S. **sanctions legislation** against Iran if the Hong Kong bank is buying for a fund which includes Iranian residents.

- The sale may violate U.S. **insider trading** rules because the bond is listed on the New York Stock Exchange. The use of the dollar payment system may be enough to attract U.S. jurisdiction over the alleged insider trading.

- If the sale price paid by the Hong Kong bank is paid on behalf of a customer and represents **criminal proceeds** or a bribe or even just a breach of fiduciary duty by a director, the Hong Kong bank may be dragged into litigation in the U.S. on the basis of the fact that it has a branch there. The Beijing bank may also be dragged into litigation on the basis of allegations that the Beijing bank should have seen red flags alerting it to the fraud or breach of duty or if there are allegations of conspiracy.

- The transaction may trigger an obligation of the U.S. office of the Hong Kong bank to make a **tax disclosure** which is against bank secrecy laws in Hong Kong.

Main classes of extraterritorial laws

The main classes of extraterritorial laws which affect financial markets and cause the most problems include (amongst others) those listed in the previous chapter on regulatory risks, including financial regulation, sanctions, bribery and corruption, antitrust or competition law, environmental laws, anti-money laundering laws, exchange controls, data protection and taxation such as the U.S. FATCA regime.

These regulatory laws are not harmonised and can sometimes seem arbitrary and unreasonable to firms from other jurisdictions.

Conflicting requirements

One of the common effects of extraterritorial laws is that a firm is subject to conflicting requirements. For example, the U.S. Patriot of Act of 2001 and tax legislation proposed in 2013 require U.S. companies with overseas affiliates to transfer personal data to U.S. authorities, potentially in breach of data protection or bank secrecy laws. Courts may order disclosure of personal data held by foreign affiliates as part of the disclosure of documents in connection with litigation.

Expansion of international rules

The basic rule about the ability of a sovereign state to restrict conduct is that sovereign states can only regulate conduct within their own territory. They can stop people shooting from outside into their territory and they can stop people in their territory from shooting somebody outside. These are called the objective and subjective territorial doctrines.

These principles have been vastly extended:

- In many countries **only a small part of the conduct needs to take place within the legislating state** since this is regarded as aiding and abetting a foreign violation or acting in furtherance of a violation or conspiring to violate a law. Examples are negotiating an agreement locally or using the local payment system.

- Many states, especially in the anti-trust arena, regulate conduct which takes place entirely abroad but has a material adverse effect in the territory. This is called the **effects doctrine**, as where somebody outside a territory shoots somebody else, also outside the territory, but who supports someone within the territory.

- Many states endeavour to regulate conduct where either the victim or the perpetrator are **nationals**. In the case of corporations, this can apply to companies which are locally incorporated and to those who have a local residence or a domicile.

- In a few cases, sovereign states claim jurisdiction wherever the conduct took place and whoever is involved. This is called the **universal theory** and typically applies only in the case of extremely serious crimes, such as genocide or torture.

There is no objection to universal laws where all reasonable people agree. The rule of law is common to all people. The failure arises where the policies are controversial so that what is considered fair in one state is unjust in another, or free leadership in one is tyranny in another, or what is forward-looking in one is backwardness in another.

Examples of extraterritorial jurisdiction in the case of crimes and regulatory violations

Many countries endorse their regulatory laws with passionate intensity. This is naturally true in the case of sanctions against the enemy of course, but it is also true in many other fields, eg those which in the eyes of the legislator and the population are designed to prevent the systemic collapse of the banks, to preserve the planet from climate disaster, or to stop big business from dominating the economy.

It follows from this that in these cases, the desire to ensure that the rest of the world adopts the same view is particularly powerful. Some states are messianic about their own deeply held convictions and embark on a crusade or jihad to convert everybody else. Even very slight contacts with the jurisdiction can bring a foreign resident within the exorbitant jurisdiction of the statute as countries seek to protect themselves against the foreign poison.

Examples of these slight connections include the following:

- Sending emails relating to a scheme into the jurisdiction or carrying out negotiations or signing an agreement there, especially if the object is fraud or bribery.
- The use of a payment system (such as a domestic correspondent bank) or a securities settlement system, even though the conduct takes place wholly outside the jurisdiction. This might affect, for example, the payment of bribes, contravention of sanctions legislation or insider trading in securities.
- Transactions involving a company which is listed within the jurisdiction.
- Any act within the jurisdiction, such as communications or meetings, which are in furtherance of a violation which takes place completely abroad, such as mis-selling a financial product, or carrying out a proprietary trading transaction which a bank is prohibited from carrying out under the Volcker Rule. The usual allegation is that there was a conspiracy within the jurisdiction or the acts within the jurisdiction were part of a bigger transgression and so attract enforcement attention.

There is still the question of whether the perpetrators can be caught and brought to justice within the domestic jurisdiction. This may happen if, say, directors arrive at a domestic airport or there is an extradition treaty, as in the case of the famous NatWest Three who were extradited from Britain to the United States on the basis of allegations concerning the collapse of Enron in the early 2000s.

In the U.S., the sanctions legislation can catch foreign offices or a foreign bank which has a branch or affiliate in New York. Use of the dollar payment system for a sanctions-busting operation may be enough.

Extraterritorial litigation and insolvency jurisdiction

It is noted elsewhere that both insolvency and litigation jurisdiction is extraterritorial.

Conclusion

One of the clearest trends in cross-border law now is the proliferation of law in national states. This has largely been driven by the increase in population, hence the increase in GDP, hence an increase in volatility and economic crises and hence the growth of law to deal with all of these pressures. Some extraterritorial laws are reasonable and present an advance. Others are unreasonable and retrograde.

Sovereign states have very different ideas about what to do. Hence the law is fragmenting internationally rather than harmonising. Each state then seeks to impose its own views on everyone else who comes within striking distance.

Chapter 12

Contract legal risks

Range of contracts

The whole fabric of commercial life is based on contract. Contract is everywhere – webs of invisible but potent nets and chains of rights and obligations.

The variety of contracts is stunning. They include, for example:

- Contracts of sale – for goods, oil and gas, electricity, shares, foreign exchange, land, investments, loans, anything, even body parts.
- Construction contracts, each surrounded by satellite contracts – contracts with architects, surveyors, engineers, subcontracts or supply contracts, contract bonds, insurance.
- Agency and broker contracts for all assets.
- Employment contracts, ranging from brief contracts with lowly employees to grand contracts with chief executives to contracts with labour unions.
- Contracts to make loans, syndicated or bilateral, often involving billions.
- Subscription and underwriting agreements for the issue of shares or bonds.
- Contracts to transfer money in payment systems.
- Charters and other transportation contracts, some slight, others massive, such as a long-term bareboat of a ship or aircraft.
- Other contracts for the lease or hire of equipment, such as the financial lease of an aircraft.
- Leases of land, short or long.
- Derivative contracts of all kinds – futures, options, forward contracts, credit default swaps.
- Securities lending contracts.
- Insurance and reinsurance contracts.

- Custodian contracts for investments or commodities.
- Management contracts for investments or land.
- Licences of intellectual property.
- Franchises and distributorships.
- Host government concession agreements for projects.
- Joint venture agreements between companies.
- Operating and maintenance agreements for projects.
- Guarantees, letters of credit, standby letters of credit of all kinds including indemnities.
- Agreements to create security or agreements governing repos or conditional sales.
- Outsourcing agreements.

All of these contracts create legal risks of one kind or another. Nevertheless it is possible to make some generalisations about important clauses and the validity of the contract itself.

Initial validity

The initial validity of a contract involves such matters as the powers of the counterparty, authorisations, formalities, eg whether in printed or electronic form or whether a formal document is required, such as the English deed or the civil law notarisation. Are witnesses necessary?

As regards powers, most commercial jurisdictions have protective doctrines whereby it is very difficult for a contract with an ordinary corporation to be invalidated because of lack of power. The special parties to watch are:

- **municipalities**, whose main job is just to pick up people's rubbish and not to enter into financial contracts such as derivatives contracts,
- **insurance companies**, who may be limited to insurance business and ancillary contracts,
- **international organisations**, where you have to look at the treaty for the powers,
- **trustees of a trust** – the powers have to be within the terms of the trust instrument if the party is to be entitled to be subrogated to the trust assets in the event that the trustee does not perform.

In the case of formalities, one can expect higher formalities in many jurisdictions in relation to guarantees and in relation to contracts affecting land.

Non-binding heads of terms

Commercial parties often wish to be able to negotiate heads of terms or letters of intent commercially without being bound by a contract. In some jurisdictions, the courts are ready to infer that the parties are bound if the terms are sufficiently clear, even if they have expressly said that they do not intend to be bound. Legal risk is increased if parties are committed when they did not intend to be.

Under English law it is usually sufficient to state that the heads of terms are "subject to contract" or some such clear phrase, but even this can be waived by the conduct of the parties. The best advice is to repeat the phrase "subject to contract" in communications about the contract and at frequent intervals.

Good faith

There are differences between the attitude of jurisdictions as to whether or not the parties must perform their obligations in good faith, ie be reasonable and not rely on the strict letter of the contract. There is no such doctrine in English law other than a duty not to be dishonest. The good faith doctrine may also affect the ability of a party to withdraw from negotiations after committing in principle under a non-legally binding letter.

Some jurisdictions imply concepts of good faith or reasonableness into a contract. For statements of the "good faith" doctrine for contracts, see, for example, France CC art 1134, al 3; Germany BGB S 242; U.S. Uniform Commercial Code 1-203 and Restatement (Second) of Contracts 205.

Accelerations and terminations

In relation to credit agreements, sudden accelerations of a loan like a bolt out of the blue are unusual and accelerations of major bank loans or bond issues on account of a triviality are rare in my experience. The ability of a bank to suspend new loans on an event of default is more important. Nevertheless there are cases where the ability to accelerate quickly could matter, eg where a debtor seeks to withdraw a deposit from the lender, and the lender, fearing that the debtor is unable or unwilling to pay, seeks to accrue a set-off by accelerating the loan and has to hunt around for a technical default. This situation may also arise where a creditor of the borrower seeks to attach a deposit.

Immediate acceleration could also be important in relation to secured credits and title finance (such as a repo or a finance lease) where the value of the asset is volatile (investments securities or cash) or the asset is liable to flee, eg an aircraft subject to a finance lease.

Any lack of legal predictability and certainty tends to introduce a sense of unease. Much lies in the perception of predictability. Certainty and the willingness of the courts to enforce the contract as written – which is usually between parties of equal bargaining power in our context and has been heavily negotiated – is seen as fundamental by markets. Legal systems which are accustomed to market transactions tend to honour this proposition and give primacy to the policy of giving effect to the parties' agreement, notwithstanding occasional abuse.

Thus under the famous English case of *The Laconia* (1977) AC 850, an owner forfeited a ship charter for non-payment of hire on the due date. The payment fell due on a Sunday. The charterer thought it would be okay to pay on the Monday but in fact, because the hire had to be paid in advance, the payment date should have been the previous Friday. The charterparty stated that time was of the essence and entitled the ship owner to cancel if hire was not paid on the due date. The ship owner forfeited the ship in order to let the ship at a higher charter rate which was then available in the market. *Held*: the owner was entitled to cancel the charterparty.

In another English case *The Chikuma* (1981) 1 All ER 652, the hire payment for a ship charter was short by $80 because of bank interest and charges. The ship owner was held entitled to cancel the charter under a clause allowing cancellation if hire was not made in full on the due date.

In these cases the parties had equal bargaining power and the courts held the parties to their bargain. The parties could in their agreements have made provision for grace periods or for a notice of non-payment followed by a grace period. If they did not do so, did the creditor have to wait another week? Another month? Three months? A year? The attitude of the English courts was that the parties should agree these terms and the duty of the courts was simply to enforce the bargain, unless it was plainly unconscionable.

In the context of loans, including secured loans, the English courts have held that if a loan is stated to be immediately payable on an event of default, it means what it says. In one case the bank was held entitled to send in receivers one hour after demanding repayment, ie the time allowed is that which is sufficient for the borrower to arrange the mechanics of payment via its bank, assuming that it has the money in its bank. If the court did not give effect to the agreement, a secured creditor would run the risk of committing a legal wrong in taking possession of the collateral without the right to do so.

In one celebrated Hong Kong case, which may be apocryphal, the closing of a land sale agreement was to take place at twelve noon, time to be of the essence. The buyer was held up in traffic and arrived ten minutes late. By that time the seller had terminated the contract and forfeited the deposit. It was held that the seller was entitled to do so. Twelve noon meant twelve noon.

This hard-edged approach is not adopted by many other jurisdictions. They either imply a duty of good faith or else will not permit one party to take abusive advantage of trivialities. The result is a potential loss of predictability and sometimes a legal risk.

This tough approach to the literal meaning of a contract creates problems for counterparties who are on the wrong end of the law. The approach of the English courts is that, in the absence of gross imbalance of bargaining power and where sophisticated business parties are concerned, it is up to the parties themselves to decide what their rights and obligations are.

Terminations on insolvency

The situation is considerably more complicated in relation to termination clauses on insolvency. Insolvency has dominant power to shatter contracts, destroy them, break the chain. If everybody remained solvent, it would not be totally disastrous if occasionally people did not abide by their contracts, provided that damages were always a prompt and adequate remedy for all actual and consequential losses – which often they are not. Perform or pay. Damages are not an adequate remedy if the payer is insolvent. For this reason, the core of many major contracts is devoted to reducing this insolvency risk.

Examples are:

- the crucial passage of title in sale contracts and the efforts to coincide this with payment of the price (payment against delivery),
- the insolvency of the contractor in construction contracts – vesting title to the works, collateral contracts from experts, retentions, performance and other contracts bonds, cut-through clauses allowing payment to subcontractors, termination clauses and rights to the plant and materials on-site,
- the covenants and events of default in syndicated credits and bonds,
- set-off and netting in all commercial contracts, not just in derivatives and other financial market contracts, and
- forfeiture clauses in leases of land.

Most medium or long-term executory contracts contain termination clauses which entitle one party to terminate the contract if certain events happen in relation to the other. Typical events of default are:

- non-payment (rent, price, principal or interest on a loan),
- non-compliance,
- actual insolvency,
- commencement of insolvency proceedings,
- execution by creditors, and

- others appropriate to the contract.

This is true, for example, of credit contracts, leases of land, leases of equipment, licences of intellectual property and medium-term sale or supply contracts. Sometimes the termination events are one-sided as in bank loan agreements and tenancies, sometimes they are reciprocal as in the derivatives master agreements of the International Swaps and Dealers Association, Inc.

Almost invariably liquidation laws allow a liquidator to disclaim or abandon or terminate contracts and obligations since the business must cease and the estate must be wound up. Invariably the solvent counterparties are entitled to prove for damages.

On the other hand, many jurisdictions prevent the use of termination clauses in contracts with a view to rescuing the business, in which case there is a statutory nullification of termination clauses – which are sometimes called *ipso facto* clauses. Some insolvency laws permit the administrator to transfer the insolvent's obligations to a third party, as in the U.S. The effect is that contractors can find themselves contracting with an unexpected third party.

In consumer contracts, termination rights may be overridden or special duties imposed on business counterparties dealing with consumers. Freedom of contract is overridden by mandatory rules.

Exclusion clauses

There is a considerable diversity of approach amongst jurisdictions to exculpation or exclusion of liability clauses, eg a clause excluding the liability of a manager of a bond issue or a syndicated loan for a misrepresentation or a syndicate bank agent or bond trustee from duties of due diligence.

In practice the avoidance of unfair contract terms is more relevant to individuals and small businesses than to commercial parties of equal bargaining power. For example, English cases show that the courts will give effect to exclusion clauses agreed between market counterparties on the basis of freedom of contract, except in the most egregious or unreasonable circumstances and except in the case of exclusions for fraud. If an exclusion clause does not operate, the amounts involved can be gigantic, could wipe out an institution and are generally uninsurable.

For example, there have been numerous cases in English courts where parties have endeavoured to get out of a derivative contract relating, for example to interest rates or currencies, when the bargain turned sharply against them. The usual complaint has been that the bank selling the derivative had a duty to explain the transaction or the bank misled the customer or the transaction was not suitable for the customer, contrary to regulatory rules. Except in the case of consumers, the English courts have held that where the counterparty is a sophisticated business person, they will be held to the bargain and that exclusions of responsibility will be upheld so as to protect the bank as seller. The rationale is that, if the document provides that a customer

is not to rely on the bank for advice or the customer does not understand the transaction, then the customer must get its own advice and pay for it.

Misrepresentation

One of the features of financial law is that, because the asset itself is invisible, even if wrapped up in packaging, such as a share certificate or definitive bond, the asset has to be described in words in order to be evaluated. Hence, the enormous importance of offering circulars and the like in relation to the issue or the sale of the asset, the importance of representations and warranties and the consequence significance of the exceptional intricacies of the law of misrepresentation. At one time, the law of misrepresentation was contained in a single admonition, "Thou shalt not tell a lie." Now whole books are written about lies.

You may say that a lie is a lie everywhere. However, there are some major differences as to who is responsible – notably in relation to the liability of underwriters for a prospectus for an issue of securities to the public. One of the issues here is whether the legal system habitually imposes "big pocket" liability on financial institutions and underwriters without fault and requires them to act as gatekeepers on prospectuses and to be responsible to investors for damages in the event of negligence in checking the accuracy of the issuer's prospectus.

Exclusions of liability for misrepresentation are part of the law relating to exclusion clauses generally. In any event, whatever the ultimate validity, exclusions should be express and comprehensive.

Governing law of a contract

It goes without saying that parties should expressly state the governing law applying to a contract, lest the courts apply an unexpected system after taking into account a centre of gravity or other test.

Factors which influence the choice of law include:

- non-legal preferences, such as patriotism, tradition, familiarity and convenience,
- avoidance by a party of a detailed investigation into an unfamiliar system of law,
- the commercial orientation, stability and predictability of the chosen legal system,
- the desire to coincide the governing law with the law of the enforcing forum (which may be external) – legal unpredictability may result if the court is called upon to apply a foreign law with which it is not familiar,
- the ability to use lawyers who have special experience of the type of contract concerned,

- language.

But by far the most important reason for a choice of law in major international agreements, particularly in bank loan agreements and bond issues, is to ensure that the governing law is external. The reason for this is that if the law of the counterparty's jurisdiction is chosen, such as the law of the borrower's country, then a change in that law will often be recognised by external courts except sometimes in the case of gross unconscionability or penalty.

Typical common changes of law protecting national debtors have been:

- legislation imposing a moratorium on foreign obligations,
- reductions of interest rates or a rescheduling of payments,
- requirements that payments must be made in local currency to a local custodian,
- exchange controls,
- other changes to the performance obligations of a party.

The risk is increased where the borrower is a state or is state-related or is nationally important, eg large local banks or large corporations. These interferences often arise either because of political upheavals or because of an economic depression or because the state is insolvent – all of which are events against which the private contractor seeks some defence.

On the other hand if a contractor is governed by an external system of law, then generally it is insulated against these changes.

The point is neatly illustrated by two contrasting English cases.

In *Re Helbert Wagg & Co Ltd* [1956], an English bank made a loan to a German borrower in sterling. After the accession of Hitler in 1933 a German moratorium law required the German borrower to make loan repayments to a government agency in Berlin in German marks instead of in pounds sterling. The contract was governed by German law. *Held:* the German law was effective to discharge the borrower. The German moratorium law arose under a German contract. A remarkably pure case, considering that the two countries had just been at war. The case demonstrates the supremacy of law over emotion.

On the other hand in *National Bank of Greece and Athens SA v Metliss* [1958], a Greek decree reduced the interest rates on bonds issued by a Greek bank and subject to English law. *Held:* the Greek law was disregarded and the borrower was liable to pay arrears of interest. The English governing law insulated the contract from changes in Greek law.

The rule in the United States is somewhat different. There the question of insulation depends upon whether the contract is located outside the territorial domain of the legislating estate – a somewhat more unpredictable process since the location of a contract is fictional.

There are limits on the insulating effect of the choice of external law, ie it is not possible to rely on the governing law to immunise you against all legal risks. For example,

- There may be no external assets capable of attachment.
- A subsequent exchange control in the borrower's country may be recognised by virtue of Article VIII 2b of the IMF agreement in some jurisdictions.
- Local insolvency proceedings are in the main governed by local insolvency law. Accordingly, if the party has to claim in the local insolvency – either for damages under the contract itself or for some separate claim, then the party will be subject to the rules of the foreign insolvency forum and hence subject to the interference in the contract, regardless of the governing law. This shows once again the destructive effect of insolvency and the creation by insolvency of often insurmountable legal risks.

With very few exceptions most jurisdictions uphold a choice of law except where all the contacts of the contract relate solely to another single jurisdiction.

It is generally unwise to select public international law or other general principles of law. Public international law is very thin when compared to the specific developed nature of national systems of law. In particular the position of public international law in relation to insulation is as yet unclear.

Jurisdiction

It is highly desirable to insert a forum selection clause for similar reasons whereby it is desirable to choose a governing law of a contract.

There are a number of purposes of forum selection clauses:

- **Additional forum** One purpose is to provide an additional forum outside the counterparty's country for enforcement and the adjudication of disputes. The party has the option of proceeding locally or, if a local action would be barred or futile for some reason, bringing the case in an external forum.
- **Insulation** Another object is to protect the insulation achieved by the choice of an external governing law. This objective might be defeated if the only available forum for enforcement is the courts of the counterparty's country since those courts will typically apply their own mandatory laws, eg a moratorium or an exchange control.

- **Forum and governing law** Governing law and jurisdiction are theoretically separate in the sense that the courts of commercial countries will not decline to adjudicate a contract merely because a foreign system of law applies. Nevertheless it is desirable that the forum should follow the governing law in order to confer greater predictability. At the most basic level, the courts of the country of the governing law will be familiar with their domestic law and are hence more likely to arrive at the expected result. In addition courts almost invariably apply their own rules of private international law in matters of contract and the rules of the governing law may be overridden by a mandatory local statute.

- **Other factors** Other factors include an experienced judiciary, impartiality, commercially-oriented court procedures, effectiveness of waivers of immunity in the case of sovereign counterparties, the fact that an express submission greatly enhances the eligibility of a judgement for recognition and enforcement elsewhere, and various other advantages.

Under an EU regulation of 2000 on jurisdiction, there are specific rules on jurisdiction. Normally a defendant domiciled in a member state must be sued in that state, subject to wide exceptions. It is normally possible to select a desired jurisdiction free of most of the rules, but not all of them.

If the parties do not choose a court or if the choice is for some reason ineffective, then local courts can exercise jurisdiction on the basis of various contacts. These can be quite minimal.

There are issues as to whether jurisdiction clauses can be exclusive or one-way or must be two-way and to the extent to which these variants are honoured by a particular jurisdiction.

Arbitration is favoured in many trading and commercial contracts but on the whole it is not considered suitable for syndicated credits or bond issues except in special cases. But views differ. There are often around 20 factors which should be taken into account in making the decision between courts or arbitration. The type of transaction and the circumstances are relevant.

Chain contracts

Contract networks are often arrayed in linear chains where fulfilment of the contract in favour of the party at the end of the chain depends on the solvency of the middle party, ie there is a high degree of interlocking interdependence. In each case this fulfilment vitally affects banks and others financing one or other of the parties. The parties often go to great lengths to avert the consequences of the insolvency of the middle party or intermediary.

Some examples include:

- **Construction contracts** – where the chain of the price is employer to contractor in the middle to subcontractors.
- **Leases, licences or charters** – of land or ships, aircraft or other equipment or intellectual property, where the chain of the rent or hire on royalties is sub-lessee to middle-lessee to lessor.
- **The sale of goods** – where the chain of the price is sub-buyer to middle-buyer to seller.
- **Sub-participation of loans** – where the chain of payments is from borrower to middle-lender to sub-participant.
- **Brokers and other agents** – acting for their clients in buying or selling investments or commodities, where the chain of the price is from seller to middle agent to principal.
- **Insurance** – there is a chain of payment of losses from reinsurer to insurer to insured.
- **Banks** – there is a chain of payment from borrowers to the bank to depositors.

In each case there are various techniques of protecting the parties from the insolvency. For example in the case of construction contracts, there are trusts for retention monies held by the employer for subcontractors, pay-when-paid clauses and cut-through statutes from employer to subcontractor.

In the case of sub-participations, the sub-participant bank takes the risk of the original lender as well as the insolvency risk of the borrower.

The fact that there are these chains of contracts also gives rise to the very common outcome of domino insolvencies, as where the insolvency of one party who is a debtor of another results in the insolvency also of the other by cascade.

Other clauses

Other important clauses include:

- **Force majeure clauses**
- **Confidentiality clauses**
- **Set-off clauses**
- **Assignment clauses**

Property legal risks

Legal risks relating to real property deserve a chapter on their own.

Suffice it to say here that in a large number of countries, absolute ownership of land is not permitted. In Nigeria, for instance, land rights are limited to rights of occupancy. The occupant cannot sell, mortgage, lease or gift rights of occupancy without permission.

Consideration should also be given to the legal risks of tenancies and the availability and integrity of land title registers.

Mitigation of contract risks

Choice of law and jurisdiction or arbitration clauses are crucial. The impact of the insolvency of the counterparty on a contract, eg whether terminations are overridden should be investigated. The enforceability of foreign judgements is also an issue.

Again, we will have to deal with specific risk mitigation in a later version of this paper. Since contract has been the backbone of commerce for so long now, the thinking on contract risk is very sophisticated and refined.

Chapter 13

Litigation risks

Litigation risk generally

The commencement of litigation is generally a sign that all else has failed and the costly jousting must commence. The uncertainties of litigation, plus the stress and costs involved, make litigation extremely unattractive for business parties. The costs of a major piece of litigation can be enormous, in excess of $100 million in some cases.

Apart from regulatory enforcement actions, typical examples of private litigation claims involving banks are:

- claims for mis-selling financial products without adequate disclosure of the risk
- underwriter liability for an offering circular
- involvement in fraud by an employee or bank customer, such as bribery, insider dealing or money laundering
- wrong financial statements.

There is often an allegation that the banks should have seen a red flag.

The categories of litigation risks facing corporates are different but equally serious.

Our predictions as to the increase in GDP, especially in emerging countries, would seem to point to more and larger transactions and hence to more disputes.

In some countries, the litigation system is designed to encourage private enforcement with the result that the citizens are extremely litigious and the litigation is aggressive.

In most U.S. states, for example, the litigation rules are extremely favourable to plaintiffs. These rules include:

- Huge punitive damages for civil claims.
- Jury trials – U.S. juries are said to sometimes favour the small against the big.
- Elected judges in some states.

- No award of costs against a losing plaintiff.
- Contingent fees dependent on success.
- Class actions.
- An apparently unrestrained ability for plaintiffs to make any allegations that they like of fraud and dishonesty against a defendant, not necessarily substantiated by facts, in the hope that the defendant will be driven into giving up and settling the case out of court. It would seem that in some cases the plaintiff lawyers have a standard form. So long as it mentions fraud, aiding and abetting a crime, racketeering, conspiracy, theft, dishonesty and the like several times on each page, they just send it out and fill in the facts later.
- An exorbitantly wide discovery of documents worldwide, so that a plaintiff can conduct a fishing expedition to see if there is anything which looks bad and which might influence a jury, such as a silly email by an employee. Discovery can involve millions of documents.

The effect of the rule that there is often no award of costs against a losing complainant and that fees are contingent and dependent on success means that a complainant has no cost risk and the scales are weighted in his or her favour.

The effect can be menacing of defendants prior to trial under the cloak of judicial immunity. The hope of the lawyers is that, if they make sufficiently damaging allegations, however unfounded, they will be able to extort a settlement out of a firm just in order to get rid of the costs and harassment of litigation.

The United States is not the only country to have a litigation system which is not favourable to banks and corporations or to foreign firms as defendants.

The conduct of those who habitually overreach in litigation is rendered even more egregious when they claim, as they usually do, that they are doing this in the cause of morality and justice. Lawyers are guardians of the legal order, not its destroyers. They bring the magnificent U.S. legal system into disrepute. As Geoffrey Chaucer remarked in the 14th century, "If gold rusts, what will iron do?"

Class actions

The essence of the class action by a representative claimant is numerosity of claimants and common issues. All members of the class are bound by judgment or court approved settlement. The court must certify the class to ensure fairness.

The objects are access to justice by claimants, the defendant has to face one action only, judicial economy, decreasing costs and the avoidance of inconsistent judgments.

The problems are that class actions encourage litigation and open the floodgates. In the U.S. the combination of the plaintiff-orientated litigation rules lead to settlements favourable mainly to the lawyers – typically 33% of the award, a few million, while each claimant receives only a tiny amount or a free voucher to buy Cheerios cereals or a GM truck. Damages may be paid into litigation funds to cover the different situations of class members. Abuse by U.S. litigation strike entrepreneurs was restricted by the Private Securities Litigation Reform Act of 1995 and the Securities Litigation Uniform Standards Act of 1998, but still many U.S. class actions are settled for large sums in advance of court proceedings. Some claims have run into many billions.

Long-arm jurisdiction

The problems of litigation are compounded by the fact that most countries in the world claim an exorbitant or excessive long-arm jurisdiction in the sense that minimal contacts with a jurisdiction are sufficient to enable a plaintiff to start an action in the jurisdiction. In English-based jurisdictions, for example, it is sufficient (outside EU cases) that the transaction is to be performed in England or is governed by English law. In some Napoleonic jurisdictions, the fact that the plaintiff is a national is enough. In most jurisdictions outside the common law group (also in England) the mere presence of an asset within the jurisdiction is enough, such as the bank account. This is called the toothbrush or umbrella jurisdiction.

Often the local courts are supposed to refuse to exercise jurisdiction if they think the action could be more appropriately brought elsewhere where there are stronger connections. But often it is the case that the courts do assume jurisdiction even on the basis of very slight and evanescent contacts.

The result is that international businesses have substantial exposure to litigation in a great many different countries, including those where the litigation is abusive or the courts are unsatisfactory. The potential to bring claims in different jurisdictions often leads to a race to issue proceedings first in the forum favoured by the plaintiff.

Most courts have power to order attachment of assets prior to a judgment to prevent their escape – these attachments can sometimes be worldwide, as in the case of the English courts.

Intellectual property risks

Intellectual property is often the crown jewel of a company's assets. As much as three-quarters of most organisations' value and revenue sources are derived from intellectual property, intangible assets, and the proprietary competitive advantages that IP offers. Many jobs depend either directly or indirectly on sectors that make intensive use of IP.

A number of points may be made about IP risks.

- There has been a dramatic rise in multi-jurisdictional patent litigation in both the information and communication technology and life sciences sectors. In the life sciences sector there has been a proliferation of multi-jurisdictional pharmaceutical patent wars in the face of competitive markets and aggressive generic entry. In addition most major pharmaceuticals are facing the expiry of patents covering blockbuster drugs; the "patent cliffs" of their chemically synthesized and biological drugs and the consequent market entry and fierce competition from generics and biosimilars, keen to secure a share of their markets, often supported by national health authorities eager to reduce their national health care bills. Successful entry can lead to a vast erosion of their earnings.

- Non-practicing entities are often created specifically to hold and produce revenues from patent assets through licensing (and often litigating aggressively to enforce the licence), and do not generally manufacture products based on patents. Operating companies sometimes transfer their patent portfolios to these entities. There are significant advantages to this idea but there is a growing concern that the new business model, alienating as it does the patents from their manufacturing or operational source, can become a tool for harmful patent litigation.

- In some emerging markets there is a lack of adequate legal infrastructure and a growing protectionism limiting the effective protection and enforcement of IP rights. In the light of this there is an increasing interest in bilateral investment treaty arbitration as an alternative to court litigation in an attempt to shape laws in the IP owners' favour.

- The law of trade secrets – the least harmonised of IP laws – often provides inadequate deterrence to misappropriation of trade secrets.

- There is a rapidly expanding use by companies of the cloud to store valuable intellectual property, personally identifiable information, medical records or customer data and other information outside a corporation's firewall. Open access is often an imperative and cloud computing helps make that possible. However, issues surrounding IP protection in the cloud, where arguably legal policy is failing to keep pace with technological developments, often seem "cloudy" and this can generate legal risks.

- Computers, the internet, mobile devices and electronic transactions all play an important and ever-increasing role for banks and corporates, particularly for businesses with a strong online presence. But the continued growth of cyber technologies carries a number of risks. In particular cyber-attacks, such as denial of service attacks, pose significant risks to businesses. Cyber attackers are often quick to spot the potential vulnerabilities of new technologies and to exploit them to commit civil and criminal offences (and to frustrate detection). Risks include damage to reputation, business interruption, financial loss, litigation, costs, loss of IP and confidential information and regulatory sanctions.

Mitigation of litigation legal risks

Topics to be discussed in a later version of this work include:

- the role of jurisdiction and arbitration clauses
- the role of mediation
- document retention policies
- simple do's and don'ts
- managing a crisis and fire-fighting
- preparing for regulatory actions
- media relations.

Chapter 14

Rule of law risks

Distinguishing the written law and how it is applied

A rating of legal risk should measure two aspects separately. These are:

- The written or black letter law or what the law says – law on the books.
- How the law is applied and what the legal environment is like in practice, ie the legal infrastructure of a jurisdiction, how the government behaves, and adherence to the rule of law.

For examples, as regards legal infrastructure, the basic law in Congo-Kinshasa and Belgium derives from the same roots, but the application is very different. There are many similarities between the written legal systems of, say, Malawi and England, or Brazil and Portugal, or Turkey and Switzerland, but there are significant differences in doing business in these countries so far as the application of the law is concerned.

One of the main objects of a legal risk rating is to endeavour to measure what the differences are. If we were to measure black letter law and legal infrastructure or the rule of law together, we would just get a noise or a blur.

Legal infrastructure and rule of law risks include such things as expropriations, governmental or judicial corruption, very inefficient courts, high crime levels and a lack of personal security, civil war or terrorism, political killings, arbitrary arrests, a lack of independence of the judiciary, political instability and the abusive exercise of power.

The rule of law is a universal secular religion which everybody believes in. It is a fundamental theology which has been at the foundation of our societies from antiquity. It is inconceivable that we could have any sort of society without some rules, however basic. The hierarchy of legal needs shown in chapter 3 demonstrates that money, banks and corporations are considered to feature early on in the ladder or hierarchy of legal needs, only just above basic criminal and constitutional laws protecting human rights and protecting the individual from arbitrary and despotic government.

Because banks and corporations represent wealth, and therefore power and control, it is not surprising that they should be the object of attention by delinquent governments and hence vulnerable to unlawful takings, to unlawful manipulation and to intrusions which prejudice the rule of law.

The rule of law is functional and is necessary for survival. Morality is not some academic waffle but fundamentally satisfies the desire for utility and benefit over costs. The rule of law and justice are necessities, and not a sentimental ideal unrelated to the pragmatic real world. Some examples are given below.

Money

It is important to understand the role of money.

Money is not just a medium of exchange – for buying things. Money connects us to other people who live abroad. It enables people to export and import so that the produce and manufactures of the world can be shared. It forms a vital link between different peoples and societies.

Money also connects us to our future, once it is transformed into financial assets such as bank deposits, bonds and shares. These financial assets are the ultimate store of our work and labour, the fruits of our efforts, which we can keep for our future, especially when we are old.

It is therefore clear that money is a public utility of enormous importance in people's lives. It is the commons. Because of the importance of money, it engages the rule of law.

Inflation

The most common example of financial oppression which leads to an injustice and therefore legal risk is the inflation of money. Inflation has been a favourite tool of despotic governments or of negligent governments from historical times, way before the Romans, back to the Greeks. Inflation is now much easier because in virtually all countries there is no longer any link between money and some asset such as gold. The link with gold was weakened by the 1930s and was abandoned altogether in the early 1970s when the U.S. abandoned the right of holders of the U.S. dollar to convert into gold at a fixed price.

John Kenneth Galbraith observed that it was repellent (or some word to that effect) how easy it is to create money. Nowadays central banks do not even have to print it. They can just buy government bonds from banks and pay the price by simply sending an email to the banks advising them that the central bank owes those banks several hundred billion or any figure the central bank cares to name. These banks can then lend out the money and it multiplies.

In very simplistic terms, if the central bank and the banking system double the amount of money available, then it will be worth half as much. One of the effects is that debtors only have to pay half as much and creditors only receive half what they are owed. There is therefore a massive redistribution from creditors to debtors and the taking away of the money of creditors, pensioners and savers simply by virtue of the fiat of the central bank.

In most countries, inflation is now recognised as being a corruption and a threat to the rule of law, an unacceptable legal risk because it functions like an expropriation without compensation. All of the main central banks in charge of the main currencies in the world are subject to an express or implicit duty to control inflation. They can usually do this by virtue of their power to reduce the supply of money and by virtue of other powers, eg to fix interest rates, or at least short-term interest rates.

Pricing of money

Central banks also have the power to manipulate the price of money, in other words the interest rates which people pay to borrow money.

They can do this by virtue of their power to create money and to lend it at whatever low price they like to banks with the result that banks can borrow money from the central bank very cheaply, if the central bank so chooses, and the banks can then lend it on at these cheaper rates plus a marginal spread to reflect the risk of the ultimate borrower and to give the banks a profit for their work.

This power to price money is most potent in relation to short-term deposits and borrowing. It is harder for the central bank to do this for longer-term loans, such as medium-term bonds of, say, seven to ten years. Nevertheless it is still possible for central banks to manipulate long-term rates.

The pricing of money at a very low interest rate, or at a negative interest rate after tax and inflation, has a similar effect to inflation. The money which central banks are pricing does not belong to the central banks, even though they create it. The money belongs to depositors with banks, savers. It is their money that is being priced high or low.

Pricing money very cheaply is to the advantage of borrowers and to the detriment of creditors, including depositors with banks. Unless it is solely the result of market forces, it is no different from a coercive or forcible taking away of somebody's car or house by governmental authority and selling it to somebody else at half-price. Effectively there is a compulsory distribution from creditors to debtors, just as in the case of inflation. Of course, the pricing policy can be justified by sound reasons. But these reasons have to be cogent and transparent.

The fact that this power to price money can lead to very substantial losses and legal risk, so that the rule of law is engaged, is shown by the course of the financial crisis commencing in 2007. From about the year 2001, the U.S. Federal Reserve priced money at an interest rate of around 1%. Apart from an initial impetus to soften the impact of the bursting of the dot.com bubble, presumably the low pricing was because there was no need to control inflation and hence raise interest rates and because there was a desire to encourage homebuyers, to enhance the ability of U.S. companies to compete with other countries by having cheap money and generally to boost the economy. An advantage was also that low interest rates would make it

cheaper for the U.S. government to borrow from abroad, such as borrowings from China. It is also sometimes said that the fall in interest rates was due to excessive liquidity from other countries.

In any event the result was a borrowing spree as borrowers borrowed money from banks for virtually nothing, ultimately leading to a bubble in the housing market.

What was an issue in relation to the pricing policy was not just that it ignited a bubble which was fanned by irresponsible lending by banks. The problem lay in the fact that the pricing of money, that is, the money of the people, was a compulsory redistribution and in particular a redistribution otherwise than through the tax system, a redistribution which was opaque to the general public. You can of course justify redistribution. But this ethical question never seriously entered the policy debate. Most borrowers did not appreciate that they were receiving somebody else's money at a coercively reduced price.

The chain of events was that the low pricing of money was one of the direct or indirect causes, plus others, which led to a bubble, mainly in the housing market. The bubble led to a sudden collapse in prices which in turn led to the collapse of banks. The collapse of banks resulted in massive bankruptcy risks which required the injection of large amounts of taxpayer money. The catastrophe then led to the introduction of a new bubble of law in the form of regulatory statutes and in the form of strong-arm resolution statutes covering the insolvency of banks and involving the nationalisation of bankruptcy law. The pricing of money was therefore one of the factors, along with others, which resulted in a fantastic increase in legal risk. This is why morality is functional.

Exchange controls

Exchange controls are regulations which typically prohibit residents of a country from holding foreign currency or foreign currency securities, or from paying in foreign currency or borrowing in a foreign currency. Residents must surrender all foreign currency proceeds to the central bank in return for the local currency at a prescribed rate of exchange.

The object is to give the central bank a monopoly of foreign currency and therefore to be able to ration it, control the supply of money and to control the exchange rate between the local currency and foreign currency.

Exchange controls are a significant intrusion on freedom. If you cannot move your money, you cannot move and are a slave to the land. If you cannot pay for foreign things without some permission, then this impacts on freedom of trade. Exchange controls strike at the heart of freedom of movement, freedom of trade, freedom of business and freedom of capital.

However, there are situations where a case can be made for the imposition of exchange controls. Such a case might be where the state is insolvent or where there is a run on banks so the exchange control is in effect a

bankruptcy moratorium. Exchange controls were ubiquitous in both developed and emerging countries until the 1980s.

As with other rule of law risks, exchange controls are a significant legal risk for banks and corporations which have investments in countries which impose those controls.

Sovereign insolvency

Nearly half the sovereign states of the world became bankrupt, in the sense that they were unable to pay their debts as they fell due, during the 25-year period between 1980 and 2005: see the map "**State Insolvency 1980 – 2005**" in chapter 3. Since then a number of other states have been bankrupt, including Greece in 2012. The reason that states become bankrupt is not invariably mismanagement. Sometimes it is bad luck or an external event such as an economic depression in other countries.

Nevertheless, state bankruptcy has so far been mainly a feature of emerging countries, with the remarkable exception of Greece in 2012. The bankruptcy of a state can have a hugely adverse effect on the legal risks experienced by those with businesses in the country or those with financial or trading links with the country. Sovereign bankruptcy often leads to the bankruptcy of local banks and corporations and a precipitous decline in the value of the local currency.

Indexes of legal infrastructure and of the rule of law

A number of organisations compile indexes which variously measure legal efficiency and the rule of law. Some of the most prominent indexes are the *World Bank Doing Business* indexes, indexes prepared by the Heritage Foundation on economic freedom and indexes prepared by the World Economic Forum on global competitiveness. There are also the corruption perceptions index prepared by Transparency International and the rule of law indexes of the World Justice Project.

Some of these indexes are shown in colour-coded form in volume II of this work, "**Legal Infrastructure Tables**". The indexes represented in the tables are as follows:

1. GDP per capita

2. Human development index

World Bank Doing Business

3. Starting a business

4. Construction permits

5. Employing workers

6. Registering property

7. Getting credit

8. Protecting investors

9. Paying taxes

10. Trading across borders

11. Enforcing contracts

Heritage Foundation

12. Investment freedom

13. Financial freedom

14. Property rights

15. Economic freedom overall

These indicators are taken from a much larger number of indexes on economic freedom proposed by the Heritage Foundation. These are grouped into ten freedoms, each with a number of subordinate variables. These freedoms cover business freedom, trade freedom, fiscal freedom, government spending, monetary freedom, investment freedom, financial freedom, property rights, freedom from corruption, and labour freedom.

World Economic Forum

16. Property rights

17. Judicial independence

18. Court efficiency

19. Global competitiveness overall

These indicators are taken from a huge array of indicators which go to make up the Global Competitiveness Index prepared by the World Economic Forum. Their indexes have 12 pillars which are in turn sub-divided into further indexes. There are about 119 variables which are divided up into indexes on key indicators (which are GDP, population, GDP per capita and GDP as a share of world GDP) and then the ten pillars,

which are: pillar one – institutions (divided into 22 variables such as property rights, judicial independence and efficiency of the legal framework in settling disputes); pillar two – infrastructure (nine variables); pillar three – macroeconomic environment (including government budget balance and inflation (five variables); pillar four – health and primary education (ten variables); pillar five – higher education and training (eight variables); pillar six – goods market efficiency (16 variables), pillar seven – labour market efficiency (eight variables); pillar eight – financial market development (eight variables); pillar nine – technological readiness (nine variables); pillar 10 – market size (four variables); pillar 11 – business sophistication (nine variables); and pillar 12 – innovation (seven variables).

World Justice Project

20. Stable laws

21. Expropriation

22. Independent courts

23. Overall rule of law

These indicators are also taken from a much larger set. The World Justice Report ranks countries according to eight factors (which have a number of sub-factors). The eight factors are (1) limited government powers. (2) absence of corruption, (3) order and security, (4) fundamental rights, (5) open government, (6) regulatory enforcement, (7) civil justice, and (8) criminal justice. Each has between three and seven or so sub-factors.

Transparency International

24. Corruption perceptions

The colouring method used is chainsaw art. Each index is divided into four with the best at the top and the worst at the bottom.

The top quarter is coloured **blue**.

The next quarter is coloured **green**.

The third quarter is coloured **yellow**.

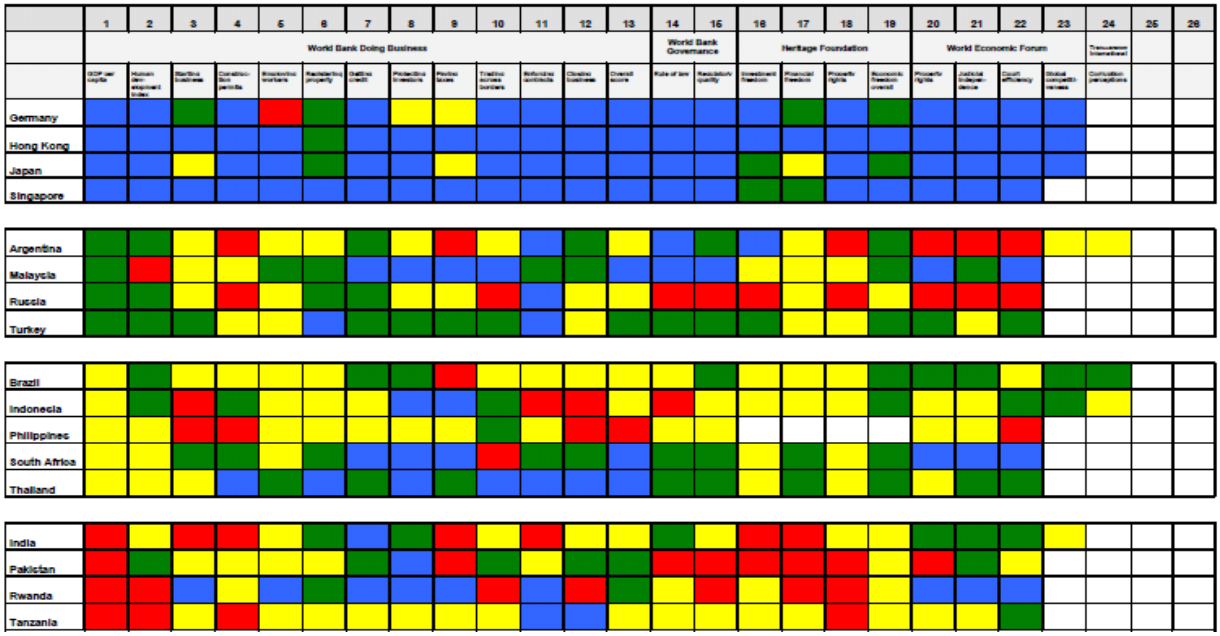
The final quarter is coloured **red**.

There are other methods for dividing up the gradings but this seemed the simplest and most visible.

Examples of these indexes are shown in the table below.

Legal infrastructure ratings

This table shows illustrative samples of the rating of the legal infrastructure of selected jurisdictions based on the data provided by external institutions.



The full tables are shown in volume II of this work.

There is no question that the work carried out by the index compilers has made a major contribution to advancing knowledge in this area and is of great value. The compilers have poured huge resources and expertise into their projects, a major and convincing international effort on a grand scale.

However, there are some limitations to the indexes. Some of the judgements appear quite subjective. The indexes often do not distinguish between black letter law (or the written law) and how the law is applied, so that there is a commingling of concepts. If one measures too many things at once, one might end up with simply a blurred noise without sharp tune.

There is another result which is extremely important. The tables in volume II first list the countries alphabetically and then according to GDP per capita. The GDP tables group the high income countries with a high GDP per capita as blue (shown in the first column), those with a medium to high income as green, those with medium to low income as yellow, and those with a low per capita income as red. They therefore compare the rankings in the indexes of legal infrastructure or legal efficiency or the rule of law *according to GDP per capita*.

On the whole the tables show that countries which have a high GDP per capita tend to have a good legal infrastructure and rule of law. A blue GDP per capita produces mainly blues in the indexes. On the other hand, very poor countries have a weak legal infrastructure and weak rule of law. Red GDP per capita countries have a red legal infrastructure or rule of law. The other ranks in the middle – green and yellow – tend to follow the same pattern.

Accordingly GDP per capita is a powerful indicator of legal infrastructure. The effect is that the main point often proved is that poor countries have poor legal infrastructure and rich countries have a good legal infrastructure. If this was all the indexes are measuring, then all we would need to know is GDP per capita.

If the purpose of an index is to prove that the rule of law depends upon wealth and prosperity and therefore that countries should pursue policies which enhance wealth and prosperity, then that case is well proven by the surveys.

There are many exceptions to the proposition that all we need to know is GDP per capita. If a blue GDP high income country has red in the indexes, there needs to be an explanation. On the other hand if a red and poor GDP country has many blues in its indexes, then this also merits investigation as to what they are doing right and why.

The tables are useful in conveying a generic result which intuitively seems about right. But they are quite broad. The measurement of legal risk, apart from the legal risks contained in the written law, involves much more detailed variables and would require colossal banks of hard data to prove them one way or the other, as opposed to the opinions of experts.

This is no more than further evidence of the general validity of the chart "**Complexity of phenomena**" shown in chapter 4 as to the inherent complexity of the law and hence of legal risk.

Mitigating rule of law risk

As before, a discussion of how to mitigate rule of law risks will be included in a subsequent version of this work.

For the moment, it is worth mentioning:

- the importance of bilateral investment treaties, how they work and how transactions should be structured to take advantage of them;
- the role of export credit agencies and governmental political risk insurance; and
- other risk mitigants which have reached a high degree of sophistication in project finance.

Chapter 15

Legal risk and the role of lawyers

Legal risk and the number of lawyers

The differences between jurisdictions in the number of lawyers practicing per jurisdiction raise some fascinating and intriguing questions, and the extent to which the number of lawyers is related to legal risk.

If we extrapolate from a sample of countries representing rich, medium-wealth and low-wealth jurisdictions, it would seem that there may be between five million and seven million licenced and active legal practitioners in the world, ie not far from one lawyer per thousand people. If, however, we estimate figures for particular jurisdictions, there are some quite colossal discrepancies. For example, the ratio in the United States is about one lawyer per 265 people, with Brazil close behind with one per 326. Canada is one per 390 and New Zealand is also one per 390. The usual figure for rich jurisdictions is somewhere between these ratios and one per 600 or so – Spain one lawyer per 394, UK one per 401, Italy one per 480, and Germany one per 590. But in France the ratio appears to be around one per 1,000 and in Sweden, the ratio seems much higher, perhaps one per 2,000.

The ratios in Latin American jurisdictions are much higher than in other middle income countries, for example, one lawyer per 550 in Argentina. This compares with around one per 1,300 in Turkey, one per 1,700 in Poland and one per 2,600 in Russia.

Amongst poor countries, one can expect from one lawyer per 3,000 up to one per 10,000 or so. For example, in Kenya the ratio is one per 6,000, and in Nigeria one per 3,708.

There seem to be around one million lawyers in India, roughly the same number in the United States, but India has nearly four times the population of the United States so the ratio is quite a high ratio of one per 1,200 or so, compared to one per 265 in the U.S.

By contrast, the ratio in China seems to be about one per 14,000 with a total of 110,000 lawyers (up from 200 over the last 20 years), but this may be a large underestimate.

In a country like Indonesia the ratio appears to be about one per 10,000. Compare this to Tunisia (one per 1,350) and Philippines (one per 2,400).

The first issue is, who do we count as lawyers? These figures, which we have not verified from official sources and which may also be out-of-date, seem to relate only to licenced and active practitioners. They

apparently do not cover inactive or retired practitioners or (often) in-house lawyers, or qualified lawyers who then went into business, or the separate professions of notaries, barristers entitled to appear in court, legal executives (paralegals) or compliance experts, or those with a law degree but who never qualified formally as practitioners, or students, or indeed judges or academics. So the actual number of lawyers may have to be increased by quite a substantial percentage.

A great many of the licensed practitioners will not be business lawyers but rather criminal lawyers or "high street" lawyers, ie those dealing with family and home matters, consumers and small litigation, such as debt-collecting or individual negligence claims.

Some of the discrepancies are easily explicable. For example the ratio in Japan is one per 4,000 or so, but this flows from the fact that in Japan the situation is (or was) that less than 10% of candidates pass the bar exams each year. This either means that the exams are too hard or else that Japan restricts the number of lawyers for policy reasons, eg because the culture regards litigation as evil in the sense that disputes should be resolved amicably, or else because lawyers represent some other sort of threat.

The discrepancy between ratios in other developed countries may therefore have something to do with a cultural view about the usefulness of lawyers, especially a perception that lawyers foment unnecessary litigation and strife. In the United States there are 15 times as many lawyers per person as in Japan. This may be attributable to a legal system which encourages litigation. The U.S. is extremely litigious, in sharp contrast to Japan. A high proportion of members of the U.S. legislative bodies are lawyers, much higher than in other developed countries.

The number of lawyers may be limited by a restrictive practice to benefit existing lawyers.

Apart from these cultural considerations, there is a clear correlation between the degree of economic development and the number of lawyers, that is, the richer the country, the greater is the number of lawyers. This may in turn be influenced by the fact that richer countries tend to have more complicated laws especially in the fields of regulation and the like, laws which are the product of the welfare state which tends to flow over into protective regulation, such as financial regulation, health and safety rules or consumer credit protections. Richer countries will have more and larger banks and corporates, therefore more transactions that have to be documented and therefore more disputes.

At any rate, if there is anything in our predictions about the increase in GDP over the coming two decades, then this would seem to point to an increase in the number of lawyers worldwide as currently poor countries get richer. At the simplest level, there are more commercial deals and more arguments about those deals. The larger amounts justify the use of lawyers in the deal or the recourse to expensive litigation. In addition, excessive regulatory or other statutes lead to a demand for lawyers who have to interpret these statutes and help resolve conflicts driven by the aggressive legal framework. Every time something goes wrong, it is the

population at large who clamour for more laws to punish the villains. The politicians respond to this righteous indignation by promising legal vengeance.

There are many conclusions which one might debate. Some are worth mentioning here.

The first issue is about the future size of law firms and of the legal and compliance departments of international banks and corporates. If we continue to inflate our legal systems as we are doing now, and if there is an increase in worldwide wealth and hence the volume and complexity of transactions, then this may point to the fact that international law firms and in-house legal departments are currently too small to cope with the risks, as well as the transactions.

The legal and compliance costs of complying with regulation of dubious worth and with legal risks are considered unjustifiable. If the U.S./Brazil model is followed, then wealth expansion, coupled with population and wealth growth, over the next two decades might result in an increase of the number of global lawyers from the estimated current six million to 12 to 15 million, give or take a few million.

A second conclusion would be that countries which are now in the emerging bracket and which therefore have less extensive legal systems than are found in developed countries should consider very carefully whether they should adopt the legal policies of the West or should strenuously resist enlarging their legal systems in the way that the West has done. It is worth them considering whether the West's jurisdictions have made mistakes in their legal development which should not be followed by emerging countries.

The fact of the matter is that many emerging countries still have roughly the same traditional business laws – whether common law, Napoleonic or Roman-Germanic laws which were adopted a century or more ago and which they have not transformed. Is there a lesson here that they should pause before they necessarily accept the advice of foreign legal consultants who press for the making of changes to emerging countries legal systems in order to "bring them up to date"?

As to whether legal costs, which are currently very high, will come down or go up will depend on a large number of factors, including the supply of lawyers, the width of their education and the attitude to risk of the business community which uses legal services.

A larger perspective

In this conclusion it is worth standing back and examining the general role of lawyers so as to achieve a proper perspective.

The law is the one universal secular religion which everybody believes in, although they may differ, and usually do, about the scope and content of the codes of this religion. Unlike many other religions, belief in the law, the role of law and the rule of law, does not require a belief in the supernatural. You can believe in

other supernatural religions in parallel. This religion does not require a showing of commitment to the codes in the form of rituals or attendance at churches or temples or in the form of other outward marks of identity. This religion is not regional or local but is universal. Because much law appears to be driven by emotion, and because its enforcement is sometimes pugnacious and bellicose, it is one of the primary tasks of lawyers to instil rationality, common-sense and a measured coolness, as well as tolerance.

The law has its sects and its cults. It has heretics and fanatics. Some of its priests are venal and corrupt. But on the whole its adherents, namely the entire population of the earth, want it to work.

If law is a form of restriction on the freedom of human conduct, the rationale is that restrictions are necessary for survival, that is, if we indeed are to continue our existence here on the earth, then we need prescriptive codes of behaviour which limit our propensity to anarchy and savagery.

In the modern world these prescriptive codes go far beyond basic human rights and freedom from arbitrary despotism, slavery and torture. Companies, banks and capital markets are artificial creatures of the legal imagination, no less fictional than dreams, but still extraordinarily potent and marvellously inventive as engines of economic growth, of technology and enterprise. These were the invention of lawyers, as were constitutions, the criminal law and the rest of the legal edifice. Overall, the lawyers' contribution has been fundamental in promoting the most primitive objective of preserving the species and building creative and ingenious structures to do it, including in the fields of productive enterprise and business.

It is remarkable to observe that, in their many fruitful debates about the underpinnings of economic growth, economists, from a profession which has done so much to shed light on our societies, have come around to view that what really matters is "institutions". By this the economists mean not just cultural but legal institutions. They also refer to "contracts and property rights" as being crucial in enhancing economic potential, ie the rule of law.

It is often said that economists are primarily interested in function, usefulness, utilitarianism, efficiency and in the weighing of costs and benefits in terms of money. By contrast, it may be said that lawyers, by their training, are more inclined to consider morality, justice, individual freedom and the rule of law. That may well be true but the argument here is that morality is the most functional of all disciplines because it is about survival.

There seems little doubt that much of the incomprehensibility and size of the law at present is driven by emotions. Many of the laws which we have, particularly the most excessive laws, are not the products of rationality or scientific and enlightened debate or of a measured coolness or of careful empirical work. Hence there are more, far more, risks of a legal sort than there need to be.

Set out below are two tableaux of world leaders, one in the left hand panel and one in the right hand panel. For those unfamiliar with all of the figures, the gentleman in the middle top of the left hand panel is Fidel Castro and the gentleman to his right is the French revolutionary terrorist Robespierre. The question is whether there is a connection between the people in the separate two groups.

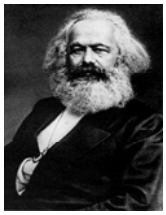
The answer is that all of the individuals in the left hand group are or were lawyers or were trained as lawyers, whereas none of the individuals in the right hand group, it is believed, had any legal training. One cannot say that the jobs that people carry out form their mind sets, but the issue remains as to whether those in the left hand panel represent some special ideology, whether or not they were good at achieving that ideology.

Part of the answer may be found in comparing the heroes of, say, economists, who play a major role in policy making, and the heroes of lawyers.

The heroes of economists include those set out in the left hand panel below. These are Adam Smith, Karl Marx, David Ricardo, John Maynard Keynes and Milton Friedman. You could add others, such as Friedrich A Hayek. The point is that they are all fairly recent and indeed economics is a fairly recent discipline in terms of the larger scale of history.

Who then are the heroes of the lawyers? This is a question that I have often put to lawyers and which puzzles them. Tentatively, they might mention Grotius of Justinian or some well-known judge. In fact, the first lawyers are of, much, much more ancient heritage. Some of them are shown in the panel on the right hand panel, namely the man on the mountain with his ten bullet points (Moses), Mahavira, the founder of Jainism, who died about 527 BC, Jesus Christ, who died around 30 AD, Siddhartha Gautama, the founder of Buddhism, who died about 483 BC, Confucius who died about 479 BC, Mahomet, the founder of Islam, who

died in 632 AD represented by a black box, and Socrates, who died about 399 BC. These individuals were amongst the first people to introduce legal codes which were fundamentally about survival.









The larger role of lawyers is therefore clear. They are very close to peoples' emotions, they are close to meticulous detail, they are close to morality as the bedrock of survival. Indeed, although they are not priests or rabbis or imams or brahmins or religious leaders, they are the true inheritors of the first lawyers who were these things and who did write commandments and moral codes about the principles of survival. Lawyers are the guardians of the moral order.

The result is that lawyers are central to the evaluation of the legal risks which the law creates so that the law remains an instrument of freedom and not of oppression and loss.

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