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ARTICLES

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COMMERCIAL LAW
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CONTENTS

ARTICLES

SOFTWARE TRANSACTIONS IN TRANSNATIONAL COMMERCIAL LAW
Akshay Shreedhar 184

FREEDOM OF CONTRACT UNDER STATE SUPERVISION
Dr. Hao Jiang 202

NOTES

PUTTING ISIS OUT OF BUSINESS FULLY LEVERAGING THE INTERNATIONAL
EMERGENCY ECONOMIC POWERS ACT TO MORE EFFECTIVELY COUNTER
COMMODITY-SELLING TERRORISTS
Bryan M. Burack 255

CRISIS IN THE PERSIAN GULF: THE PATH FOR REFORMING QATAR'S
COUNTERTERRORISM FINANCING REGIME
Alex M. Jensen 277

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SOFTWARE TRANSACTIONS IN TRANSNATIONAL COMMERCIAL LAW

Akshay Shreedhar*

INTRODUCTION

The importance of software trade in the modern world can only be understated. Some of the highest revenue earning companies in the world are software companies.¹ Many of the “most innovative companies” have regularly been acknowledged to be software companies.² It comes as no surprise that leading market forecasters predict a US \$100 billion market for the gaming industry (software based video games) alone by the end of 2018.³

Consequently, in the realm of transnational commercial law, software transactions are quite important. While parties to an international commercial contract are free to choose which law will apply to their contract, most “software trading nations,” with the exception of India, Brazil and the UK, are now signatories to the United Nations Convention on Contracts for the International Sale of Goods (“CISG”).⁴ The question therefore arises, and has often been the subject of intense debate:⁵ how do we classify these software contracts? In other words, can a software contract be regarded as a “contract of sale of goods” in the sense of international sales law? It is surprising that even the most venerable legal texts devote only a few paragraphs to this “commonplace product,” and the related issue regarding applicability of sales laws in general.⁶

As legal commentators, lawyers, and students of the law, we often deal with the phenomenon of trying to pigeonhole ideas into existing concepts, and scholarly opinion has noted that this is at times not only convenient, but

*The author is a law graduate (B.A., LL.B (Hons.)) of National Law University, Delhi, 2015. The first draft of this paper was submitted as part of the seminar paper in the ‘International Business Transactions’ course offered by Professor Murdoch Martyn, taken by the author while on an exchange program in Osgoode Hall Law School, Canada in the Fall of 2014.

¹ Michael L. Rustad & Maria V. Onufrio, *The Exportability of the Principles of Software: Lost in Translation?*, 2 HASTINGS SCI. AND TECH. L.J. 25 (2010).

² *Id.*

³ *DFC Intelligence Forecasts Global Video Game Software Industry to Reach \$100 Billion in 2018*, DFC INTELLIGENCE (June 25, 2014), <http://www.dfcint.com/wp/dfc-intelligence-forecasts-global-video-game-software-industry-to-reach-100-billion-in-2018/>.

⁴ CISG: TABLE OF CONTRACTING STATES, <http://www.cisg.law.pace.edu/cisg/countries/cntries.html> (last updated Jan. 8, 2016).

⁵ Sarah Green & Djkhongir Saidov, *Software as Goods*, J. OF BUS. L. 161 (2007).

⁶ *Id.*

necessary.⁷ In any international transaction, the fundamental expectation of parties is that the rules which govern the transaction must be coherent, fair and workable in practice.⁸ Predictability of such rules is invaluable – for the “limits of our language are the limits of the world.”⁹ The position of software contracts in CISG, which ultimately ends up governing many international transactions,¹⁰ is unsettled. This fact alone ought to be viewed as a warning bell for the need to settle this legal uncertainty.¹¹

This article will begin by giving a brief description of the issue and the factors leading to this problem. The courts and academics have not been silent and have discussed the issues that this difficult question of classification of software poses. However, in trying to lay down a certain set of rules in order to reach a solution, the jurisprudence is, at best, unclear and needs to be relooked.¹² Software contracts initially were classified based on insignificant factors like ‘tangibility’ and ‘mode of delivery.’ This article will address the issues surrounding these erroneous modes of classification and will argue for an approach that considers software independent of these factors (Part II). The correct way to classify software should be based on simple yet elegant concepts presented in international sales laws like the CISG. Indeed, there is now an increasing acceptance of the notion of “transfer of property” for a “sale of goods” (Part III). Further, with every software transaction, complications arise due to certain intellectual property (IP) rights issues. While this field of law is independent and distinct, a recent judgment by the European Court of Justice (“ECJ”)¹³ has shed some much needed guiding light on the issue of classification of software contracts (Part IV). Finally, in moving forward, and in the interest of uniformity of interpretation, many suggestions and critiques have been made regarding the law governing software transactions, and a closer look at these is needed (Part V).

⁷ J. W. Carter, *Article 2B: International Perspectives*, 14 J. OF CONT. L. 54, 55-56 (1999).

⁸ *Id.* at 56.

⁹ Trevor Cox, *Chaos Versus Uniformity: The Divergent Views of Software in the International Community*, 4 VINDOBONA J. OF INT’L COM. L. AND ARB. 1 (2000).

¹⁰ See U.N. COMM. ON INTERNATIONAL TRADE LAW, UNITED NATIONS CONVENTION ON CONTRACTS FOR THE INTERNATIONAL SALE OF GOODS, U.N. Sales No. E.10.V.14 (1980) [hereinafter CISG].

¹¹ Frank Diedrich, *Maintaining Uniformity in International Uniform Law via Autonomous Interpretation: Software Contracts and the CISG*, 8 PACE INT’L L. REV. 303, 303-04 (1996).

¹² Green & Saidov, *supra* note 5; St. Albans City and Dist. Ct. v Int’l Computs. Ltd. [1996] EWCA Civ. 1296 (Q.B.), <http://www.bailii.org/ew/cases/EWCA/Civ/1996/1296.html>.

¹³ Case C-128/11, *UsedSoft GmbH v. Oracle Int’l Corp.* (2012), <http://curia.europa.eu/juris/document/document.jsf?jsessionid=9ea7d0f130d53b065d7fef7e4fd4acdd813149bafbe0.e34KaxiLc3eQc40LaxqMbN4Och8Re0?t>.

I. THE PROBLEMS IN CLASSIFICATION OF SOFTWARE CONTRACTS

A. *The Nature of Software Transactions*

It is important to first understand and appreciate why software transactions create such complications. The answer lies in the nature of both the “subject matter” and the “transaction.” Software refers to a set of instructions given to a computer to perform a certain function. It is perhaps this definition that makes matters complicated for software classification. It is difficult to imagine how a “set of instructions” will fit the traditional concepts of goods. Software is considered equivalent to “knowledge” or “information,” which are not capable of being sold as goods.¹⁴

The corporate response to the sales of software being treated as “goods” was in the form of what is commonly known as End User Licensing Agreements (“EULAs”), whereby the software is “not sold, but licensed.” This transaction is hard to classify as a sale, because the license holder is merely given a “right to use” the software, but does not really own it.¹⁵ The nature of the transaction brings into question whether or not ownership is required to be transferred in cases of a sale.

One might question why companies prefer licensing the products instead of simply selling them. After all, when a book is sold, there is a “sales” transaction and the book is now owned by the reader, even though he does not have a right of ownership over the ideas or words used in that book. The reason why copyright owners prefer the licensing model, instead of simply selling software, is that software can be easily copied or duplicated.¹⁶ As such, software owners may further sell the software to others, because under the “first sales rule” of IP law, they are not prohibited from doing so.¹⁷ The seller therefore loses the opportunity to sell to a potential buyer.¹⁸

Software contracts are not always this straightforward. Very often software is bundled with other products such as hardware, and, in such

¹⁴ Marcus G. Larson, *Applying Uniform Sales Law to International Software Transactions: The Use of the CISG, Its Shortcomings, and a Comparative Look at How the Proposed UCC Article 2B Would Remedy Them*, 5 TUL. J. INT'L & COMP. L. 445, 453-56 (1997).

¹⁵ Hiroo Sono, *The Applicability and Non-Applicability of the CISG to Software Transactions*, in SHARING INTERNATIONAL COMMERCIAL LAW ACROSS NATIONAL BOUNDARIES: Festschrift for Albert H. Kritzer on the Occasion of his Eightieth Birthday 520 (Camilla B. Andersen & Ulrich G. Schroeter eds., 2008).

¹⁶ *Id.*

¹⁷ *Id.*

¹⁸ *Id.*

cases, what forms the predominant part of the transaction is the determining factor in classification.¹⁹ In other cases, software may be customized specifically for the buyer. In such cases, an argument in favor of exclusion of sales laws is that “provisions of services,” and not “delivery of goods,” formed the preponderant part of the seller’s obligations.²⁰ The tests in these cases are established by a long line of cases and academic opinions,²¹ which do not provide a predictable set of legal rules.

B. The Drafting History of the CISG

While legislative intent is an often-used principle in the interpretation of law, as far as the CISG is concerned, arguments which rely on giving weight to the legislative intent in determining whether it applies to software transactions must be disregarded. In fact, arguments can be made, both in favor and against CISG’s applicability on the basis of legislative intent. On the one hand, it can be argued that if the legislators intended to exclude software from the CISG, they would have placed it on the list of excluded items in Article 2.²² Yet, at the time the CISG was finalized, “software” as a trading commodity, did not even exist.²³

While the CISG does not define goods, it is surprising that no attempt was even made to define it in its legislative history.²⁴ It has been suggested that the CISG must be perceived to have “a life of its own,” whereby it can accommodate and adapt according to changing circumstances.²⁵ However, this reasoning is based on the notion that in cases of treaties and conventions with a large number of member states, it is quite hard to reach an agreement and conclude such pacts.²⁶ The same notion of perceived difficulties in concluding agreements between different countries has been highlighted in the drafting history as well.²⁷ As such, the strength of this argument is based on practical observations, rather than going by either the letter of the law, or the true intention of the legislators. At best, it can be

¹⁹ CISG, *supra* note 10, at art. 3.

²⁰ *Id.*

²¹ Professor Pilar Perales Viscasillas (Special Rapporteur), *CISG Advisory Council Opinion 4*, (Oct. 24, 2004) [hereinafter CSIC-AC No. 4].

²² CISG, *supra* note 10, at art. 2.

²³ Sono, *supra* note 15 (quoting the example of how IBM’s decision to split hardware and software marked the turning point, or rather, the starting point in software trade in 1980).

²⁴ Larson, *supra* note 14, at 449 n. 22.

²⁵ Frank Diedrich, *The CISG and Computer Software Revisited*, 6 VINDOBONA J. OF INT’L COM. L. & ARB., 55, 60 (2002).

²⁶ *Id.* at 61.

²⁷ Larson, *supra* note 14.

concluded that the intention of the CISG's legislators was not final in this regard.²⁸

C. The Irrelevance of "Tangibility"

One of the most significant hurdles that hinders software from being classified as a "good" is the notion of tangibility. Therefore the basis for this notion must be explored. Both civil and common law systems require physical possession for "goods."²⁹ Believing that possession is not possible for intangibles, they consequently assert that things like software must be outside the scope of "goods." However, it has been argued that legal notions of tangibility must be updated in order to conform to the complexities of the digital age.³⁰ For software, this can be done in two ways: first, by adopting an approach to "prove" that software is in fact tangible or satisfies the rationale for tangibility; or second, that the requirement of tangibility for goods in itself is obsolete.

Regarding the first approach, it is inappropriate to simply assume that software is intangible. Both hardware and software have a material form. Software is not merely an idea or a right, it is an "arrangement of matter" that is ultimately placed on some tangible medium.³¹ Software takes the form of what are called "bits." These bits are stored on pits in a surface (CD-ROM), a series of magnetic switches (flash drives), or a series of electric pulses (electronic downloads).³² The net result is that software exists on some tangible medium. Therefore, it will exist on the physical memory of the system and most certainly will occupy some space.³³

Regarding the second approach, even if considered intangible, there is no good reason to limit the applicability of international sales law to tangibles. In fact, intangibility of software was not a hurdle in classifying it

²⁸ Diedrich, *supra* note 25, at 60.

²⁹ See BENJAMIN'S SALE OF GOODS 61-62 (A. G. Guest et al. eds., 6th ed. 2002); A. P. SERGEYEV & Y. K. TOLSTOY, 2 GRAZHDANSKOE PRAVO 13 (1997).

³⁰ Green & Saidov, *supra* note 5, at 165.

³¹ MICHAEL KOENIG, DIE QUALIFIZIERUNG VON COMPUTERPROGRAMMEN ALS SACHEN IM SINNE DES SEC. 90 BGB 2604 (Neue Juristische Wochenschrift 1989); Green & Saidov, *supra* note 5, at 166; South Cent. Bell Telephone Co. v. Barthelemy, 643 So.2d 1240, 1246 (La. 1994).

³² Sarah Green, *Can a Digitized Product be the Subject of Conversion?*, 4 LLOYD'S MAR. COM. L. Q. 568 (2006); Duncan M. Davidson, *Protecting Computer Software: A Comprehensive Analysis*, 23 JURIMETRICS J. 337, 341-345 (1983).

³³ B. L. Horowitz, *Computer Software as a Good under the Uniform Commercial Code: Taking a Byte out of the Intangibility Myth*, 65 BOSTON U.L. REV. 129, 133 (1985).

as a “good” in quite a few instances.³⁴ Even though scholars have argued that a rebuttable presumption would exist whereby intangibles are presumed services, and tangibles are goods, no reason can be derived from the CISG to limit its sphere of application to tangible things. According to a noted legal scholar on this subject, Professor Frank Diedrich, “anything that can be commercially sold, in which property can be passed which is not excluded from the CISG by virtue of Art. 2, can be the subject matter of a contract of sale, i.e. goods, pursuant to Article 1(1) CISG.”³⁵ Software is movable, transferrable, and capable of being sold and possessed (by limiting access to the system it is stored on), so “intangibility” should not be a hurdle to its classification as a good.

There is yet another justification for disregarding barriers raised by intangibility. In any commercial contract, the intention of the parties is to be given prime importance.³⁶ Consider a hypothetical situation involving two software engineers, whereby an “exchange” of software may be understood radically differently. After all, for software engineers, “software” can literally be penned down on a piece of paper and given to another engineer who can make use of it. However, in the kind of transactions that are governed by the CISG, the intention and interest of the parties is not to obtain software in this sense (penned down on paper). It is to obtain recorded knowledge stored in some sort of physical form that their equipment could use. It is, therefore, imperative that the software is not just “information” to be comprehended. If it were, it could not be put to use by the buyer.³⁷ Rather, the software is given a more “physical” existence to make certain desired physical things take place.

D. *Mode of Delivery Is Misleading*

It is almost unanimously accepted across jurisdictions that software delivered in a tangible medium, such as a disk or a tape, is a sale of goods.³⁸

³⁴ *Advent Systems v. Unisys Corp.*, 925 F.2d 670 (3rd Cir. 1991); Hof’s-Hertogenbosch [District Appeal Court] Nov. 19, 1996, No. 123 NEDERLANDS INTERNATIONALE PRIVAATRECHT [NIPR] 175-77 (Neth.); *Pace Review of the Convention on Contracts for the International Sale of Goods (CISG)*, KLUWER L. INT’L 365, 365-72 (1998).

³⁵ Diedrich, *supra* note 25, at 64; L. Scott Primak, *Computer Software: Should the U.N. Convention of Contracts for the International Sale of Goods Apply a Contextual Approach to the Question?*, 9 COMPUTER L.J. 197 (1991).

³⁶ See CISG, *supra* note 10, at art. 8. The CISG particularly recognizes this principle in Article 8: “(1) For the purposes of this Convention statements made by and other conduct of a party are to be interpreted according to his intent where the other party knew or could not have been unaware what that intent was.”

³⁷ John M. Shontz, *Computer Software: Time to Pay a Fair Share*, TAXES—THE TAX MAGAZINE 168 (1990).

³⁸ See Diedrich, *supra* note 25; Green & Saidov, *supra* note 5.

However, this view is severely misleading, since it takes the focus away from the actual subject matter of the sale, to *how* the sale is delivered. In fact, there is no basis for using “mode of delivery” to characterize software. The purpose behind buying software remains unchanged irrespective of the mode of delivery.

Indeed, academics have criticized this “unfortunate situation” where the law changes with respect to a software transaction with a change in mode of delivery.³⁹ The software can be transferred in any form, pursuant to the needs and conveniences of the contract.⁴⁰ Even if delivered in a tangible medium, the software would ultimately be stored in the memory of a processing system. The medium would therefore be separated from the software. This is bolstered by the fact that the medium is almost always of little value as compared to the content.⁴¹ It would therefore be absurd to differentiate between two transactions involving the same subject matter, merely because the mode of delivery has changed. A scholar went on to call this unjustified classification on the basis of delivery, as differentiating between beer sold in a bottle and beer sold from the tap.⁴² It is interesting to note here that this very comparison was questioned by Professor Hiroo Sono in his article, wherein he stated that “beer itself is clearly tangible.”⁴³ While this may seem like an apt rebuttal, it still does not justify any approach which would give due regard to the mode of delivery (which, in the author’s opinion was precisely the point Professor Diedrich made in his “beer from a bottle/tap example”).

An issue might be raised here regarding “downloaded” software. It can be argued that since electricity is excluded from the scope of the CISG under Article 2, software downloaded electronically is also excluded. However, as electricity is merely a medium for the software, it should be disregarded. Such transfer can also be done via fiber-optics, cellular transmissions and other new technologies, which could soon render electronic transmissions useless, and avoid this restriction of the CISG.⁴⁴ It would also be contrary to the uniformity requirement under Article 7(1) of the CISG to interpret software downloaded electronically from external

³⁹ Green & Saidov, *supra* note 5, at 166.

⁴⁰ Diedrich, *supra* note 25, at 64.

⁴¹ Horovitz, *supra* note 33, at 133.

⁴² Diedrich, *supra* note 25, at 64.

⁴³ Sono, *supra* note 15, at 521.

⁴⁴ Larson, *supra* note 24, at 471.

servers as not being a good,” especially when the buyer’s intent remains same in every case.⁴⁵

II. THE CORRECT CLASSIFICATION OF SOFTWARE TRANSACTIONS

A. A Positive Definition for “Contract of Sale of Goods”

This article has discussed primarily what approaches should not be taken for the purposes of defining goods, or for classifying software as a “good.” The question remains however, what is the definition of “goods?” The CISG does not provide a definition. This fact has been the point of departure for two different theories regarding “goods.” The first being, since CISG does not provide a definition of goods, it must be interpreted liberally to include anything capable of being commercially traded and sold.⁴⁶ The other approach is the one adopted initially by Professor Diedrich,⁴⁷ that a definition of “goods” must be “found” within the CISG itself.

It is important to acknowledge, that to understand a part of the CISG, the structure, or the “whole,” must be understood. Indeed, CISG scholars, like Dr. Larry DiMatteo have noted “... a body of sales law rules, cannot be understood without knowledge of the whole; in turn, the whole cannot be understood without knowledge of the parts.”⁴⁸

Professor Diedrich termed this methodology as “autonomous interpretation” of International Uniform Law under the CISG.⁴⁹ The main obligations of the seller and the buyer as defined in Articles 30 and 53 of the CISG are to “deliver and transfer the property in the goods,” and “rendering payment and taking delivery of the goods” respectively.⁵⁰ It is for this reason that scholars have agreed upon a definition for “goods” as “something which can be commercially sold” or “something in which property can be transferred.”⁵¹ A “sale” can consequently be defined as a “transfer of property in goods.”

However, this creates a circular problem within the definitions. While a “sale” is the transfer of property *in goods*, *goods* in themselves are things which *can be sold* or in which property can be transferred. Nevertheless, the adoption of this approach would lead to a two-step process for how

⁴⁵ Peter Schlechtriem, *Requirements of Application and Sphere of Applicability of the CISG*, 36 VICTORIA UNIVERSITY OF WELLINGTON L. REV. 781 (2005).

⁴⁶ See generally Diedrich, *supra* note 11.

⁴⁷ See Diedrich, *supra* note 25.

⁴⁸ Larry DiMatteo, *Critical Issues Under the Formation of Contract in the CISG*, ANNALS FAC. L. BELGRADE INT’L ED. 67, 69 (2011).

⁴⁹ Diedrich, *supra* note 11, at 310.

⁵⁰ CISG, *supra* note 10, at art. 30, art. 53.

⁵¹ *Id.* at art. 30.

software can qualify as goods. As mentioned earlier, since software is an “arrangement of matter” which can be possessed and excluded, it seems to be something which can be sold or in which property can be transferred. The question therefore becomes, *has* the software really been sold? This should be the *most significant* question that must be answered for determining whether or not the CISG applies. While this will be explicated in subsequent sections, before proceeding, the overlap between goods and services must be considered.

B. *The Distinction of the “Nature of Subject Matter”: Goods Versus Services and the Implications of Article 3 CISG*

Given that the definition of “goods” should be considered from an essentially “property based” criteria, services would clearly be a separate entity from goods. Apart from elements of customization, and specific manufacture (considered later in this section) there have not been many meritorious arguments for considering software transactions as services. There is however, a clear line between two entities being considered as “goods” or “services.”⁵² Two significant points have been raised by scholars who consider software contracts as service contracts. First, any production of software content involves a high level of intellectual expertise, therefore the value of software, which is essentially a set of instructions, does not lie in the material with which the software is made, but in the actual labor put in by the people who made the software.⁵³ This argument is further augmented (in some cases) by the “custom” nature of software that is specifically produced for the buyer’s needs.⁵⁴ However, just because software is made “particularly for a buyer’s needs, the nature of the transaction (*i.e.*, sale of goods) does not necessarily change. In fact, any product requires extensive services, creativity and manpower in making it “ready-to-use.”⁵⁵ Indeed, within their price matrix, most goods have

⁵² Fiona Smith & Lorna Woods, *A Distinction without a Difference: Exploring the Boundary between Goods and services in the World Trade Organization and the European Union*, 12 COLUM. J. EUR. L. 1, 32 (2005).

⁵³ Primak, *supra* note 33, at 63.

⁵⁴ Diedrich, *supra* note 25, at 63.

⁵⁵ Robert Holmes, *Application of Article 2 of the Uniform Commercial Code to Computer System Acquisitions*, 9 RUTGERS COMPUTER & TECH. L.J. 1, 115 (1982); *see also* Diedrich, *supra* note 11, at 330; *Analysts Int’l Corp. v. Recycled Paper Prod., Inc.*, No. 85-C-8637, 1987 U.S. Dist. LEXIS 9410 (N.D. III. Oct. 7, 1987).

considerations given to such elements, and this mere fact should not change their classification as goods.⁵⁶

By making the software specifically for the buyer's needs, a seller is merely doing what any manufacturer does for the buyer who has ordered goods that are not yet produced. Any "custom-designed" good is covered under the CISG. Article 3(1) provides for such situations where a good has yet to be manufactured.⁵⁷ The wording of Article 3(1) is a testament to this, which states that "[c]ontracts for the supply of goods to be manufactured or produced are to be considered sales unless the party who orders the goods undertakes to supply a substantial part of the materials necessary for such manufacture or production."⁵⁸ It creates a positive condition for applicability of the CISG, as opposed to Article 3(2) which starts with "[t]his convention does not apply...."⁵⁹ As long as the buyer does not supply a substantial part of the materials necessary for such manufacture or production, the software contract must be considered a sale of goods. If the buyer supplies *data* for the production, the situation might be more complicated.⁶⁰ Some scholars argue that if the buyer supplies a substantial part of the material, then he *owned that substantial part* of the final product to begin with, in which case the application of the CISG would not be justified.⁶¹ This rationale does not apply to cases in which the buyer provides data since the operating part of the software is independent of the data used to develop it.⁶² It could be argued that "data," being intangible information, should not be included within the scope of the word "materials" in Article 3(1). However, taking such a stance would conflict with the notion of tangibility's irrelevance in considering software as goods. The idea being: if tangibility does not play a role in software's classification as goods, why should it play a role in deciding whether "materials" in Article 3(1) will include "data"?

Secondly, it has been noted that often in software contracts the delivery of software is accompanied by various support services, such as installation support, system support, program support services and training.⁶³ Under such circumstances, the ideal situation would be to apply

⁵⁶ Loukas Mistelis & Anjanette Raymond, *Article 3, in UN CONVENTION ON CONTRACTS FOR THE INTERNATIONAL SALE OF GOODS (CISG)* 60 (Stefan Kröll, et al. eds., 2011).

⁵⁷ Diedrich, *supra* note 25, at 63.

⁵⁸ CISG, *supra* note 10, at art. 3(1).

⁵⁹ *Id.* at art. 3(2).

⁶⁰ See CSIC-AC No. 4, *supra* note 21.

⁶¹ P. SCHLECHTRIEM AND I. SCHWENZER, COMMENTARY ON THE UN CONVENTION ON THE INTERNATIONAL SALE OF GOODS (CISG) 55 n.14, 57 (Oxford 2d ed. 2005).

⁶² Sono, *supra* note 15, at 522.

⁶³ Green & Saidov, *supra* note 5, at 172-73.

Article 3(2) of the CISG. Since “services” are required to be provided to the buyers under these software contracts, the contract would be a mixed contract involving sale of goods as well as services/labor. These still lie within the realm of the CISG, and even if the buyer has other obligations than to take delivery and pay the price, it does not change the fact that the CISG is applicable on the basis of Article 3(2).⁶⁴ The only restriction is that such obligations must not amount to a “preponderant part” under Article 3(2) of the CISG which reads: “This Convention does not apply to contracts in which the preponderant part of the obligations of the party who furnishes the goods consists in the supply of labour or other services.”⁶⁵

In order to determine the preponderant part under the contract for the application of Article 3(2), two different criteria may be employed: economic or essential.⁶⁶ The “essential criteria” is generally applied when it is impossible or inappropriate to ascertain the economic value of the different obligations.⁶⁷ If there is a “bill of costs” or some other acceptable way to determine the value of each component under the contract, then the “essential” criteria is rendered irrelevant.⁶⁸

Under the “economic criteria,” for something to be preponderant in the sense of Article 3(2) of the CISG, the value must not only be at least fifty percent, but should be significantly higher.⁶⁹ Further, any value that has been attributed to “development/making/designing of software” must not be considered “services.” This is so because under Article 3(2) of the CISG, components that have been used to produce the final product are generally regarded as part of the “goods.”⁷⁰ Further, a court has held that “software is not a commodity which is delivered once, only once and for all, but one

⁶⁴ Franco Ferrari, *Specific Topics of the CISG in the Light of Judicial Application and Scholarly Writing*, 15 J.L. & COM. 1, 61 n.404 (1995); Tuula Ämmälä, *International Trade in Finland - the Applicable Rules* 5 TURKU L.J. 85-105, at ¶3.3 (2003); CSIC-AC No. 4, *supra* note 21; ICC Arbitration Case No.7153 of 1992 (Hotel materials case), <http://cisgw3.law.pace.edu/cases/927153i1.html>; Handelsgericht [HG] [Commercial Court] Zürich, July 9, 2002 (Switz.), <http://www.unilex.info/case.cfm?id=1515>.

⁶⁵ CISG, *supra* note 10, at art. 3(2).

⁶⁶ Viscasillas, *supra* note 21. The black letter rule 9 states that “[i]n interpreting the words ‘preponderant part’ under Article 3(2) CISG, primarily an ‘economic value’ criterion should be used. An ‘essential’ criterion should only be considered where the ‘economic value’ is impossible or inappropriate to apply taking into account the circumstances of the case.”

⁶⁷ CSIC-AC No. 4, *supra* note 21, at, ¶3.3; Landgericht [LG] [Regional Court] Mainz, Nov. 26, 1998 (Ger.); Cour d’appel [CA] [regional court of appeal] Grenoble, Apr. 26, 1995 (Fr.).

⁶⁸ CSIC-AC No. 4, *supra* note 21, at, ¶3.3.

⁶⁹ Mistelis & Raymond, *supra*, note 56, at 54, 58.

⁷⁰ *See id* at 60; Oberlandesgericht [OLG] [Higher Regional Court] Karlsruhe, June 12, 2008 (Ger.), <http://openjur.de/u/350192.html>; Oberlandesgericht [OLG] [Supreme Court] Jan 1, 2002 (Austria), <http://cisgw3.law.pace.edu/cases/020114a3.html>.

which would necessarily be accompanied by a degree of testing and modification.⁷¹ Even under the essential criterion of Article 3(2) of the CISG, since generally the very purpose of the software is to obtain the proper functionality of the hardware, the transaction is dominantly a sale of goods or at least should be presumed to be so. This approach is similar to considering a computer, involving both hardware and software, as a good, and therefore eliminates the problems of “turnkey” contracts or “bundled” contracts.⁷²

C. *The Distinction of the “Nature of the Transaction”: Sales versus Licenses*

The goods/services distinction has another issue that has cropped up as a result of recent popular “online database access” services. These services may be classified as software contracts, although they consist primarily of the “right to use” the database content online. This question however, can be better answered by placing it under the “sales/license” distinction, since the issue is more closely related to the nature of the transaction as opposed to the nature of the subject matter.

Very often, we come across software transactions in the form of what is commonly known as “shrink wrap agreements,” which ask a customer or user to click a checkbox acknowledging his or her acceptance of the software agreement before proceeding with the transaction. It is a very common practice for companies to now use the phrase in that agreement “This software is licensed, and not sold.”⁷³

However, as pointed out by certain scholars,⁷⁴ this phrase in essence refers to the IP in the software and not the proprietary rights in the “sales” sense. The reason for this is simple. Consider selling a book to a person -- this transaction will no doubt be considered a sale of goods. However, that does not mean that as a purchaser of the book, the person has a right to copy the contents of the book and further sell them. In fact, the right to exploit

⁷¹ *Saphena Computing Ltd. v. Allied Collection Agencies Ltd.* [1995] F.S.R. 616 (Eng. C.A. 1988).

⁷² *Toby Constructions Products Pty Ltd. v. Computa Bar (Sales) Pty Ltd.* [1983] 2 NSWLR 48; *St Albans City and DC v. Int'l Computs. Ltd.* [1996] 4 All ER 481; *Oberlandesgericht [OLG] [Provincial Court of Appeal]* Oct. 16, 1992, 1993 Köln (59-61) (Ger.).

⁷³ John Walker, Thought: *Do We Own Our Steam Games*, ROCK PAPER SHOTGUN (Feb. 1, 2012, at 1:18 PM), <https://www.rockpapershotgun.com/2012/02/01/thought-do-we-own-our-steam-games/>. While this may be observed in numerous everyday software, consider an example of the gaming service “steam,” widely popular for online gaming, where the question “who really owns the games” remains unanswered.

⁷⁴ Green & Saidov, *supra* note 5, at 164-66.

the uniqueness of the content will always lie with the original author. However, proprietary interests of the purchaser may still exist. The book, and, by analogy, a particular copy of software, will simply be the property of the purchaser.⁷⁵

In cases of the book, there is an implied licensing agreement between the author of the book, and the reader, where the reader is entitled to “access” the content. Similarly, there is an implied “sales” agreement between the user of a software and the seller, regarding *his* particular copy of the software. A license entitles the licensee to possessory and proprietary interest in the “copy” of the software that he has received. The right to exploit the intellectual property of the software still remains with its creator.⁷⁶ The question now arises: how is the “transfer of property” criteria fulfilled? Since the CISG does not define “property,” it can be said to include limited property rights, and the “right to use” as well. Therefore a limited property right in the form of a license must amount to a “sale.” However, not every such license can and should be, qualified as a sale. The word “transfer” would imply two very important connotations. First, the license must be of a permanent nature, and second, it should be for the payment of a one-time fee. This is so because for a “transfer” to take place, it necessarily implies that there is no act that the “transferee” may commit such that his title in the property may be relinquished. In other words, with the conclusion of the contract, the seller must relinquish all of his rights in the said property (to the extent discussed above) so that the buyer is now entitled to the exclusive use of the software. This would make the license, a functional and economic equivalent of a “sale,” since there would be no realistic expectation of the software’s return.⁷⁷ Hence, in an example of a software company selling to a purchaser, the company cannot realistically expect the return of the purchaser’s copy once the transaction has concluded.

The above reasoning finds support in the CISG as well. The CISG impliedly recognizes that the word “property” in Article 30 (from which the definition for “sale” is derived) need not imply intellectual property, considering Article 42(2)(a) of the CISG, which mandates that as long as a buyer is aware of a third party’s title to the software, intellectual property

⁷⁵ *Id.*

⁷⁶ Joseph Lookofsky, *In Dubio Pro Conventione? Some Thoughts About Opt-Outs, Computer Programs and Preemption Under the 1980 Vienna Sales Convention (CISG)*, 13 DUKE J. OF COMP. & INT’L L. 263, 277 (2003).

⁷⁷ Horovitz, *supra* note 33, at 156; Primak, *supra* note 35, at 221.

claims on the said “goods” can validly exist for a valid sale.⁷⁸ In the absence of such a provision, a seller would have been obligated to deliver goods free from any intellectual property claims.⁷⁹ One may argue that this provision applies only in case of “third party” rights specifically, and not “first party” rights, therefore the *seller* must not be allowed to place any limits on the property rights (since the seller is the “first party”).⁸⁰ There are two responses to this argument. First, the property referred to in Articles 41 and 42, is intellectual property, and not the property in the sense of Article 30. Secondly, under the principles of party autonomy, as recognized in Article 6 of the CISG, the parties can always modify and derogate from these provisions.⁸¹ The license in itself is an implied derogation from these principles.

Finally, to deal with the issue of contracts permitting access to online databases, it may be stated that these contracts are very similar to software download contracts, where the information is stored on a computer. The fact remains that the elements of exclusivity and possession still exist with online database contracts since a private account is created to access these databases, which can be password protected. The “account” correlates to the concept of “owner’s copy.” However, these contracts are subject to the tests of “transfer of property” whereby there must exist a “one-time fee for a permanent access.”

III. INTELLECTUAL PROPERTY LAW: EXPLORING COMMONALITY

A. *Software Licences and the grey area in CISG*

While the notion of “transfer of property” might seem adequate for defining the “sale” and subsequently “goods,” actual definitions for these concepts cannot be derived from the text of the CISG alone. Instead, the more convenient approach would be to use the CISG’s Article 1 implications rather literally – in other words, the requirement is that there must be “a contract of sale of goods.” This definition would therefore

⁷⁸ CISG, *supra* note 10, art. 42. Article 42 of the CISG states that “the seller must deliver goods which are free from any right or claim of a third party based on industrial property or other intellectual property, of which at the time of the conclusion of the contract the seller knew or could not have been unaware, provided that the right or claim is based on industrial property or other intellectual property ... [but] the obligation of the seller under the preceding paragraph does not extend to cases where ... at the time of the conclusion of the contract the buyer knew or could not have been unaware of the right or claim.”

⁷⁹ *Id.*

⁸⁰ Diedrich, *supra* note 11, at 58-59.

⁸¹ CISG, *supra* note 10, art. 6. Article 6 of the CISG states that “the parties may exclude the application of this Convention or, subject to article 12, derogate from or vary the effect of any of its provisions.”

“evolve” to imply that a contract of sale of goods is one in which there is a transfer of property.

In this scenario, the limitations on classifying software licenses as contracts of sale of goods is problematic. This problem was identified, and exploited by Professor Sono in his article published in 2008, where he made a comprehensive argument against the applicability of the CISG to software licenses.⁸² Professor Sono focused on the transaction, but labelled software simply as information. Therefore the conclusion was drawn that since online software is only an information trade, the property in it can never really be transferred; it can only be copied and duplicated.⁸³ Therefore, he concluded that such information can only be licensed.⁸⁴

According to Professor Sono, these licenses were now the focus of a CISG analysis of Article 3(2) whereby, the preponderant part test is applied to them.⁸⁵ Professor Sono concluded, that since in any software license, the preponderant part of the obligations of the seller would be in licensing the software, and not in the delivery of goods.⁸⁶ Therefore such transactions would be excluded from the purview of the CISG.⁸⁷ This however is a short-sighted conclusion.

For a strict evaluation under Article 3(2) of the CISG, the Advisory Council recommends that a step-by-step analysis under the economic value and essential value tests should be adopted.⁸⁸ Moreover, by labelling the transactions as licenses, the software companies cannot circumvent the provisions of sales laws, which often provide for stricter standards that sellers must comply with. Nevertheless, the author’s opinion about licenses being the equivalent of “sales” is limited to cases when the licenses are perpetual. Therefore, it is imperative to analyze what the rights of a license holder will be in the context of a software license. Fortunately, the European Court of Justice (“ECJ”) dealt with such an issue in a recent judgment, which was published in 2012.

⁸² Sono, *supra* note 15, at 526.

⁸³ *Id.* at 516.

⁸⁴ *Id.*

⁸⁵ *Id.*

⁸⁶ *Id.*

⁸⁷ *Id.* at 520.

⁸⁸ CSIC-AC No. 4, *supra* note 21.

B. The UsedSoft v. Oracle Case: Rights of user in an EULA

The UsedSoft case⁸⁹ may mark a turning point for the treatment of software licenses, though its actual effects will be seen only with time. The case was referred to the ECJ by the German Federal Court to determine the basic question of the extent of a license-holder's rights of, in other words, if it was at all possible for the owner of a license to further sell that license to another buyer.

The background of the case involved Oracle, a software company that sold and marketed software to users, which could be downloaded from an online source for a fee. These software transactions were governed by a software license agreement which specified that the users would receive a non-exclusive, non-transferrable right to use the software for a perpetual period of time, in return for the payment of a one-time fee. UsedSoft was another company which specifically dealt with second hand software. UsedSoft began offering for sale, certain "used" licences of Oracle software which were "ongoing" because the maintenance agreement between the original license holder and Oracle was still in force.

The legal provisions governing this case, included, among other rules, the European Software Directive,⁹⁰ which provided:

Article 4(1): the computer program rights holder has the exclusive right to do or authorise: (a) the reproduction of the program; (b) the translation or other alteration of the program; and (c) any form of distribution to the public of the program.

Article 4(2): the first sale of a copy of the program by the rights holder or with their consent in the EU exhausts the distribution rights of that copy within the EU (such that the rights holder loses the right to rely on its copyright to oppose the resale of that copy).⁹¹

The ECJ held that even though the software company may term the transaction as a license, as long as it is of a permanent nature, that is, it is a

⁸⁹ Case C-128/11, *UsedSoft GmbH v. Oracle Int'l Corp.*, <http://curia.europa.eu/juris/document/document.jsf?docid=124564&doclang=EN> (July 3, 2012).

⁹⁰ Council Directive 2009/24, of the European Parliament and of the Council of 23 April 2009 on the Legal Protection of Computer Programs 91/250/EEC, 2000 O.J. (L 111) 16.

⁹¹ *UsedSoft v. Oracle* at ¶12-18; Kathy Berry, *EU- UsedSoft v Oracle: ECJ approves sale of 'used' software*, LINKLATERS, (Nov. 26, 2012), <http://www.linklaters.com/Insights/Publication1403Newsletter/TMTNewsNovember2012/Pages/EUUsedSoftOracleECJapprovessaleusedsoftware.aspx> (summarizing the case along with a summary of the law).

perpetual license for a one-time fee, such a transfer of rights will qualify as a "sale of copy," which conforms to the notion of "proprietary interest transferred in the copy of the software."⁹² The Court held that such a license is protected by the first-sale exhaustion principle whereby the acquirer of license can sell his copy to another person, since the original copyright holder would have lost his rights to that particular copy.⁹³ This can be permitted so long as the user deletes his own copy before selling the software to someone else, otherwise selling the copy may amount to reselling, copying and distribution, which are rights always vested with the copyright holder and are not transferred in a "sale."

C. *Implications on Classification of Software Contracts*

The UsedSoft case provides a persuasive precedent indicating that even software licenses can be treated as "sales" contracts, as long as they are perpetual and for a one-time fee. The ECJ confirmed this notion and allowed the users of a license to transfer the rights acquired under the licenses (as long as there is conformity with the law). No doubt, certain questions remain unanswered. For example, what terms will govern the new user of the license? Or what would happen in cases of technical restrictive measures, limited term licenses and multi-user contracts? However, the court clarified one basic principle: that perpetual software licenses for the payment of a one-time fee are to be treated as sales of "software copies," consequently amounting to a sale of goods. There is no reason why courts and tribunals should not take guidance from this decision as they develop jurisprudence on this issue.

IV. CONCLUSION

This article supports the idea of software transactions being classified as a "sale of goods" for the purposes of transnational commercial law, and in particular, the CISG. Admittedly, terms and concepts remain undefined in the CISG. Sometimes, scholars use this fact to argue that the CISG must be interpreted broadly to allow for this agreement to cover different kinds of subject matter. The lack of definitions suggests that perhaps the legislators had faith that the courts and tribunals would use this deliberate ambiguity to develop a more definite set of rules. However, the element of uniformity as envisioned by Article 7 of the CISG will be jeopardized if interpretations are left to the liberty of the "homeward trend" of domestic courts.

⁹² UsedSoft v. Oracle at ¶45-46.

⁹³ *Id.* at ¶48.

The United States tried solving the problem of software transactions by passing the Uniform Computer Information Technology Act (“UCITA”), however, its success remains a matter for debate.⁹⁴ Scholars like Professor Diedrich argue that in order to avoid the uncertainty and ambiguities associated with software transactions, the parties to the contract should simply opt out of the CISG using Article 6, so that the relevant national/domestic law applies.⁹⁵ However, adopting such a solution will not contribute to solving the issue of classification of software contracts, even though it might be the most practical solution for commercial parties. The intention of the legislators, if perhaps explored in more detail from the *travaux préparatoires*, shows that the reason why “electricity” was excluded from the Convention was that they were not sure if it would be treated as goods by different countries.⁹⁶ If the CISG were debated right now, perhaps a similar argument might emerge to include a provision which excluded software transactions from its scope.

However, coming up with international legislation and getting a multitude of nations to agree to it is a difficult task. This salient feature of any international convention would imply that the provisions of such conventions should be interpreted rather broadly, simply because that is more “convenient.” Suggestions that there must be new legislation or an amendment to the CISG ignore the fact that not all of the countries would necessarily agree. Nonetheless, in moving forward, due regard must be given to the fact that trade and technology often move faster than the evolution of law. It is therefore obvious that the law needs to be given a “push” forward. This “push” can be provided by having a uniform jurisprudence which regards all software transactions (provided they fulfill the discussed conditions) as a “sale of goods.”

⁹⁴ Rustad & Onufrio, *supra* note 1, at 38-40.

⁹⁵ Diedrich, *supra* note 11, at 74.

⁹⁶ *See generally* U.N. Conference on Contracts for the International Sale of Goods, Documents of the Conference and Summary Records of the Plenary Meetings and of the Meetings of the Main Committees, U.N. Doc. A/CONF.97/19 (1991).

FREEDOM OF CONTRACT UNDER STATE SUPERVISION

*Dr. Hao Jiang**

I. INTRODUCTION: THE THEORETICAL INCOHERENCE OF FREEDOM OF CONTRACT AS A LEGAL TRANSPLANT

It has been said that Western private laws are similar in nature even when the technical rules are different.¹ This is because they share the same philosophical origins that provide similar inherent principles. Also, the increasingly globalized economy has promoted the unification of private laws, especially in the context of commercial law. Even non-Western jurisdictions have adopted Western laws in order to show the world that they comply with international standards and that it is safe for Western investors to invest heavily in these countries where they can expect legal protection like that of their home jurisdictions. Even if the technical rules and the written sources are the same, laws can be different if the rules are applied in societies that are structurally different. As Rodolfo Sacco pointed out in his seminal article, *Legal Formants, A Dynamic Approach to Comparative Law*, “The statutes are not the entire law. The definitions of legal doctrines by scholars are not the entire law. Neither is an exhaustive list of all the reasons given for the decisions made by courts.”² Nevertheless, although the rules may function differently, there are universal values any system would like to preserve. Such values include the

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¹ See generally James Gordley, *Is Comparative Law a Distinct Discipline?*, 46 AM. J. COMP. L. 607 (1998) (noting that, although the technical rules are different, relief given by Western courts may be much the same); James Gordley, *Equality in Exchange*, 69 CAL. L. REV. 1587, 1627 (1981) (noting that France, Germany, England, and the United States allowed a party to an unfair contract to obtain some degree of relief). See generally E. Allan Farnsworth, *Precontractual Liability and Preliminary Agreements: Fair Dealing and Failed Negotiations*, 87 COLUM. L. REV. 217, 239-40 (1987) (arguing that though there is no general duty to negotiate in good faith in America, courts impose similar duties as European courts would).

² Rodolfo Sacco, *Legal Formants: A Dynamic Approach to Comparative Law*, 39 AM. J. COMP. L. 1, 27 (1991).

preservation of party autonomy, fairness, and minimization of the more informed party's exploitation over the less informed.

Since late 1990s, the idea of freedom of contract has gradually become acceptable in Chinese society. In 1999, it was established as a fundamental principle of Chinese contract law code.³ The legislature, leading jurists, and the Chinese Communist Party all shared high expectations for the utilitarian advantages of freedom of contract in an emerging market economy, particularly by encouraging domestic and cross-border commercial dealings. In their opinion, China is heading towards market socialism and, as a result, freedom of contract in China will be as it is envisioned in Western contract theories, paradoxically, since these theories have been in controversy for the past century in the West.

Since the early 1990s, Chinese economic reform has signaled a transition from a planned economy to a market economy and the use of the market to allocate resources.⁴ The autonomy of the will, as it figures in Western contract theories, has been regarded as the "soul of private law."⁵ It has been argued that "freedom and openness" should replace the "the paternalistic and restrictive nature" of Chinese law.⁶

Both the formal legislative sources from the National People's Congress and two major drafters of the Contract Law code, Jiang Ping and Wang Liming, considered freedom of contract essential to the market economy.⁷ They believed that freedom of contract should be embraced to the fullest extent in order to limit the government's intervention and narrow the role of state plans, despite objections to that idea raised by Western legal theorists in the 20th century. Wang Liming emphasized the importance of freedom of contract in two of his articles introducing the new statute to the West:

Respect for the freedom of contract of market actors is a precondition of market economic development. As the freedom enjoyed by contracting parties broadens, the flexibility and self-governing nature of the market will be

³ See [Contract Law of the People's Republic of China] (promulgated by the Presidential Order No. 15, effective Mar. 15, 1999) art. 4.

⁴ See Jiang Zeming's Report at 14th Party Congress (Mar. 29, 2011) (declaring the establishment of a market economy in China and use of market mechanism to allocate resources), http://www.bjreview.com.cn/document/txt/2011-03/29/content_363504_4.htm.

⁵ 江平 张礼洪 [Jiang Ping & Zhang Lihong], 市场经济和意思自治 [*Market Economy and Autonomy by Parties' Free Will*], 法学研究 [6 LEGAL STUDIES], at 21 (1993).

⁶ See *id.* at 22.

⁷ See 孙礼海 [Sun Lihai], 合同法立法资料选 [*Selective Legislative Materials on Contract Law*] 4, 5, 法律出版社 [Law Press].

strengthened. Transactions will be promoted and, with the development of the market, society's wealth will be increased. Therefore, freedom of contract is a basic and necessary condition for the development of transactional relationships under market economic conditions. Any contract law that regulates transactional relationships should adopt freedom of contract as its fundamental principle.⁸

The position was seconded by another prominent Chinese civil law scholar, Jiang Ping. According to Jiang, "to accord parties freedom of action to the greatest extent possible is the common demand by the market economy and the autonomy of the parties' free will."⁹ Both Jiang and Wang agreed that there is a proportional correlation between the extent of parties' freedom to exercise their wills and the dynamics of the market economy.¹⁰ Unlike contemporary Russian civil law that limits the freedom of the parties to conclude a contract,¹¹ Chinese law embraces all aspects of freedom of contract and allows parties to enjoy freedom in the formation, validity, terms, termination, and choice of remedy of their contract.¹² The voluntariness principle in previous laws limited freedom of contract only to the formation of contract and imposed mandatory rules on other aspects of contracting.¹³ Now, in virtually all aspects of contracting, previously mandatory rules have given way to the mutual agreement of the parties.¹⁴

The practical legitimacy of a legal transplant such as freedom of contract will require "a conscious acceptance of the subjects of the law that is preferable" and is taken seriously in practice.¹⁵ For the freedom of contract to function in China in the same way as it has been in the West, the paternalistic features of the law and the institutions must fade away. However, with pervasive state-ownership in the economy and a less than sufficiently free and competitive market, as the prominent Chinese economist Justin Yifu Lin identified, the state will continue to interfere with

⁸ See Wang Liming, *An Inquiry Into Several Difficult Problems in Enacting China's Uniform Contract Law*, 8 PAC. RIM L. & POL'Y J. 351, 357-58 (1999).

⁹ See Jiang & Zhang, *supra* note 5, at 20-25.

¹⁰ See Jiang Ping, *Drafting the Uniform Contract Law in China*, 13 COLUM. J. ASIAN L. 1, 10-11 (1996).

¹¹ RUSSIAN CIVIL AND COMMERCIAL LAW VOLUME 2: LAW OF OBLIGATIONS 35 (William E. Butler ed. & trans., V.P. Mozolin & A.I. Masliaev, eds., 2011).

¹² See Wang, *supra* note 8, at 356.

¹³ See discussion *infra* Section III. B.

¹⁴ See *id.*

¹⁵ See PITMAN B. POTTER, *THE ECONOMIC CONTRACT LAW OF CHINA, LEGITIMATION AND CONTRACT AUTONOMY IN THE PRC* 8 (1992).

the managerial autonomy of Chinese state-owned enterprises (“SOE” or “SOEs”) through both policy burdens and soft budget constraints.¹⁶

According to Lin, the three core issues in Chinese SOE reform are asymmetry of information, incentive incompatibility, and liability disproportionality.¹⁷ These three issues have raised theoretical difficulties faced by Chinese courts in applying freedom of contract. As Lin observes, the problem of asymmetry of information arises because, with a less than competitive market, profit is no longer an effective information indicator by which the Chinese government can evaluate the performance of SOEs.¹⁸ The problem of incentive incompatibility arises because, when SOEs are not operated to maximize the profits, as the state does not possess adequate information of the enterprise performance, SOE managers naturally possess an incentive to further their own personal interest, which is incompatible with furthering the state agenda. The problem of disproportionate liability arises because, without a competitive employment market, SOE managers have little personal stake in the failure of the SOEs; the loss they may suffer is greatly disproportionate to the potential loss of the state. Because the state is unable to hold SOE management accountable for financial failures, it must limit the SOE’s managerial and contractual autonomy to prevent the abuse of that autonomies and opportunism at the expense of the state. The problems with the current contract law theories are that they do not provide courts with theoretical support regarding how freedom of contract should be interpreted differently in China to prevent state’s invasion of contractual autonomy and SOE managers’ abuse of freedom of contract.

In the West, freedom of contract emerged after competitive market had been formed and private ownership was prevalent. Will theories and classic contract law served to protect the competitive environment and restrain the court from interfering with contractual autonomy and free competition. In China, state ownership has been the rule rather than the exception. The SOEs were the only subjects under the ambit of pre-reform contract law and are still pervasive in the contemporary Chinese economy. Moreover, unlike the former Soviet Union and Eastern Europe, the economic reform started by creation of a non-state sector outside the state sector without massive privatization of the latter.¹⁹ Freedom of contract was

¹⁶ See generally JUSTIN YIFU LIN ET AL., CHINESE STATE-OWNED ENTERPRISES REFORM 181 (2001).

¹⁷ See generally *id.*

¹⁸ See *id.*

¹⁹ See Lan Cao, *The Cat That Catches Mice: China’s Challenge to the Dominant Privatization Model*, 21 BROOKLYN J. INT’L L. 97 (1995) (detailing the differences in privatizations between China and Soviet Union).

introduced while ownership had not been transferred to the private sector, and the market was not yet competitive.

Thus, from its inception, the role and function of freedom of contract in such an economy has not always been positive, especially when state-owned enterprises are involved. The state, the controlling or exclusive shareholder of these SOEs, uses a series of institutional networks to supervise the management and monitor the performance of the SOEs to advance state objectives rather than maximizing profits, and to prevent opportunism by SOE managers at the expense of the state. As a result, SOEs carry out goals that are not profit driven; they bear the policy-induced burdens but enjoy a less competitive market environment, soft budget constraints, favorable policy treatments, and subsidies. To understand how freedom of contract or the general theories of contract law work or fail in China compared to the West, it is of paramount importance to appreciate the state's difficult roles as both the referee and a player in a market where competition on a level-playing field does not occur. The two most common problems are: (1) courts, on behalf of the state and in violation of freedom of contract, allow SOEs to renege contracts, which were fair upon conclusion but turned out to be a bad bargain for the SOE, in the name of preservation of state assets and (2) courts, by affording SOE managers the protection of freedom of contract and turning a blind eye to the fairness of the transaction, allow SOE managers to reward themselves by disposing state assets at prices that are tantamount to stripping state assets.

In the first scenario, when SOEs, with the help of the state, are freely allowed to rescind contracts with private parties without committing a breach, both the entrepreneurship and market economy suffer because freedom of contract is not respected.

In the second scenario, these interests suffer because freedom of contract is respected. Even when SOE managers are convicted of corruption, abuse of power, or neglect of duty, they are only punishable in criminal proceedings; the contracts in question are not automatically invalid. The rationale is that the conviction itself does not mean that the contracts reached by these convicted SOE managers were the result of corruption; even if a contract was the result of such criminal activities, it might still be in the interest of the SOE for the contract to be valid in circumstances such as price fluctuation and market changes. If absolute nullity of such contracts were to be assumed, freedom of contract and safety of transactions would be compromised. Therefore, only the aggrieved SOE, along with its new managers and the affected private investors, shall be allowed to request judicial review of the fairness of the contract. If the transaction is determined by the court as asset-stripping, the contract should be declared null and void for its harm to public interest.

Though *laissez-faire* capitalism favors minimum state participation in the market, in reality, the state always has a role in contracting. Across the

globe, at the minimum level, such a role can be seen even in the most typical capitalist countries in government contracts or state monopoly of certain industries to ensure certain public or state interests. The state tends to have a bigger role in civil law jurisdictions such as France, Germany, and Italy than in their common law counterparts such as the U.S. and the U.K. However, it is safe to assume that in the West, outside areas such as defense, energy, and public transportation industries, the markets belong to private parties and are free and competitive in nature.

This article mainly refers to industries where a competitive market exists and it is in the public interest to treat contracting parties equally regardless of the ownership status. On this premise, it is assumed that, in Western law, the state has no role in contracting. On the contrary, the state has such a role in China, given the pervasive presence of SOEs and their dominant share in Chinese economy. A significant part of the Chinese GDP comes from SOEs, and many of the SOEs are not as strictly profit driven. Many efforts have been made to assess the percentage of the Chinese economy owned by SOEs, and the general consensus seems to be that the share would be around 50%,²⁰ even though it is impossible to have an accurate number due to the fact that pure state ownership in enterprises is no longer common. The pervasive presence of state-holding companies and the uncertain number of enterprises and industries under the direct and indirect control and influence of the state make it very difficult to ascertain the real share of state sector in the Chinese economy. Still, certain rough conservative estimates can be made. Among the 120 biggest national state-owned enterprises that are under the authority of State-owned Asset Supervision and Administration Commission (“SASAC”), it has been observed that “as of 2010, total assets of the 120 national SOEs equaled 62% of China’s GDP; total revenues were 42% of GDP.”²¹ Aside from these 120 SOEs under the central government, there are many more SOEs owned by each level of government, many of which are state-holding companies that are controlled by the state ownership. In a 2010 survey, there were 11,405 state holding companies that outnumbered the 9,105 pure SOEs.²² There were also 131 joint ventures where an SOE had ownership interest.²³ In addition, there are township and village owned enterprises

²⁰ See ANDREW SZAMOSZEGI & COLE KYLE, AN ANALYSIS OF STATE-OWNED ENTERPRISES AND STATE CAPITALISM IN CHINA I (2011).

²¹ YINZHI MIAO, OVERSEA LISTING AND STATE-OWNED-ENTERPRISE GOVERNANCE IN CHINA: THE ROLE OF THE STATE 4 (2012), http://www.law.harvard.edu/programs/corp_gov/papers/Brudney2012_Miao.pdf.

²² See SZAMOSZEGI & KYLE, *supra* note 20, at 8 (quoting National Bureau of Statistics of China).

²³ *See id.*

("TVE") owned by village and township collectives. However, there were only 9,651 companies where state ownership was not specified.²⁴ As a result, the state has a pure financial interest in the outcomes of the contracting by SOEs. Such an interest is not equivalent to public or state interest in the Western law.

When the state has a role in contracting beyond just mere regulator, the state has a conflict of interest that creates competing interests between the government and private investors, which results in difficulties in the protection of private investors. Due to the absence of a market, the state lacks a sufficient information indicator necessary to monitor the performance of SOE managers. The result is the stripping of state assets. Therefore, it is important to limit the role of the state to the extent that it is not detrimental to the economic efficiency or the fairness in contracting. When the role is too invasive, entrepreneurship and productivity in the society are harmed while the lack of state intervention results in the misappropriation of state assets.

Therefore, despite the systematic borrowing of principles from Western contract law including freedom of contract, the same laws and principles may not be easily applied in China. The root problems are those described by Lin, from which this article borrows heavily: incentive incompatibility, information asymmetry, and liability disproportionality.

In China, the market is artificially made less competitive so that SOEs can survive while pursuing non-economic goals imposed by the State. It follows that a fair amount of contracts are made between parties that are not private investors. Nevertheless, the aim of this study is not to urge that Chinese contract law and theories should disregard the wills of the parties. Instead, the goals are (1) to identify what could be validly willed by contracting parties who lack the complete power of disposition over assets; this is to prevent the abuse of freedom of contract by parties that do not bear the negative consequences of such freedom, and (2) to place limitations on the state's interference with contract which, if unrestricted, will eventually destroy freedom of contract.

In the end, despite all the differences in Chinese law and economy, the practice of contract law in China respects philosophical principles and values that Western contract law has honored since Roman law, such as equality in exchange and fairness. This article suggests that courts would not in fact honor the principle of freedom of contract to the same extent as in the West because of the difficulties that would result. The market is not

²⁴ *See id.*

sufficiently free and competitive, and significant ownership rights still belong to the state. We have seen the result in the two scenarios just described. Nevertheless, it is possible to piece together a coherent theory of contract that places substantive fairness in contracting ahead of freedom of contract in circumstances that may result in stripping of state assets or in which an SOE is attempting to shirk a bad bargain. As a result, two types of exploitation emerge. One is the SOE manager's exploitation of state interest while the other is the state's exploitation of private interest. In China, courts must impose extra limits to protect the state's interest from SOE managers and limit the freedom of the state or an SOE to renege a bad bargain with a private party. Both approaches serve to remedy the exploitations in contracting.

The first part of this article will review the history of Western legal thought on freedom of contract. The second part will discuss the pre-reform Chinese contract law that completely denied freedom of contract, its economic logic and its theoretical coherence. The third part will discuss the legal and economic reform along with the introduction of freedom of contract and its theoretical incoherence. The last part will propose a theoretical solution by considering the circumstances in which an expression of will should be held invalid.

II. FREEDOM OF CONTRACT IN THE WEST AND ITS INAPPLICABILITY IN CHINA

A. *The Rise and Fall of Freedom of Contract*

In the history of Western contract law, the battle between the preservation of substantive fairness and freedom of the will of the parties has been ongoing since the rise of 19th century will theory. At that time, freedom of contract gained its dominant role in the major Western jurisdictions such as England, the United States, France, Germany, etc. The universal acceptance of the theory gave rise to heated scholarly debates regarding the roots of the transformation. There are different accounts given to explain what happened to civil law and common law worlds.

It has been said that the rise of will theory in civil law can be traced back to the political thoughts of liberalism and individualism the jurists and code drafters shared.²⁵ In the civil law, substantive justice and fairness of the exchange were respected in the Middle Ages. Relief for *laesio enormis* allowed a contracting party to rescind the contract solely based on an unjust

²⁵ See JAMES GORDLEY, THE PHILOSOPHICAL ORIGINS OF MODERN CONTRACT DOCTRINE 214-215 (1991).

price.²⁶ Late scholastics and the northern natural law school developed the Aristotelian principle of commutative justice.²⁷ In the 19th century, jurists claimed that giving relief presupposed that value is “an intrinsic property of things” when, in fact, it depends on “the mere judgment of men.”²⁸ The remedies for unfair prices were restricted by the *Bürgerliches Gesetzbuch* (BGB) and *Code Civil* (C.CIV).²⁹

In common law, the wills of the contracting parties and their consent became the central theme of contract law only in the 19th century. From 1770-1870, according to Patrick Atiyah, the role of consensualism rose and that of reliance and restitution damages in contract law declined.³⁰ As a result, the award of expectation damages gained popularity over protection of restitutional and reliance interests.³¹ The cause of this phenomenon has been one of the major debates in the legal history of contract law. According to Morton Horwitz and Patrick Atiyah, the transformation of contract law regarding the breach of executory contracts and the rise of will theory in American law came about to meet the needs of the market economy and *laissez faire* capitalism.³² Alternatively, A.W.B. Simpson argues that the innovation in the 19th century contract law was a borrowing of systematic rules from civil law.³³

However contract law was transformed, the rise of will theories and freedom of contract did encourage free competition and protect the safety and certainty of the transactions. To do so, general theories of contract law had to be blind to details such as subject matter and person.³⁴ One of the principal characteristics of classical contract theory was “the tendency to

²⁶ A contract can be rescinded when a thing was sold for less than half of the just price. A buyer can choose to either pay the difference between the just price and the price paid or rescind the transaction. See James Gordley, *Contract in Pre-Commercial Societies and in Western History*, in INTERNATIONAL ENCYCLOPEDIA OF COMPARATIVE LAW 2-41 (J.C.B. Mohr, ed. 1997).

²⁷ See *id.* at 2-45-2-49.

²⁸ See Gordley, *Equality in Exchange*, *supra* note 1, at 1592.

²⁹ See *id.* at 1592-93 (noting that nineteenth century German commentary acknowledged that disparity in price itself is not sufficient to invalidate a contract while French commentary went further to deny the existence of just price of things).

³⁰ See generally P. S. ATIYAH, *THE RISE AND FALL OF FREEDOM OF CONTRACT* 455 (1979).

³¹ See *id.*

³² See MORTON J. HORWITZ, *THE TRANSFORMATION OF AMERICAN LAW, 1780-1860* (1977); see also ATIYAH, *supra* note 30, at 456.

³³ See generally A.W.B. Simpson, *Innovation in Nineteenth Century Contract Law*, 362 L. Q. REV. 91 (1975); see also A.W.B. Simpson, *The Horwitz Thesis and the History of Contracts*, 46 U. CHI. L. REV. 533, 589 (1979).

³⁴ See Simpson, *The Horwitz Thesis and the History of Contracts*, *supra* note 33, at 400-05.

attribute all the consequences of a contract to the will of those who made it.”³⁵ As a result, “the primary function of the contract came to be seen as purely facultative, and the function of the court was merely to resolve a dispute by working out the implications of what the parties had already chosen to do.”³⁶

The core of freedom of contract is to give binding force to whatever is mutually agreed between the contracting parties.³⁷ Thus, to ensure freedom of bargaining, which was regarded as “the fundamental and indispensable requisite of progress”³⁸ by 19th century economists, courts must not step in to rectify an unfair bargain “since the force of competition will ensure fairness in terms and prices.”³⁹

The autonomy of the free choice of private parties to make their own contracts on their own terms was the central feature of classical contract law. For this contractual autonomy to be truly established and respected, it was required that, under many circumstances, moral justice had to give way to freedom of contract.⁴⁰ Such intellectual and political movement towards liberalism and individualism in the 19th century resulted in the disfavor of the Aristotelian idea of commutative justice.

However, James Gordley presents a different account, arguing that modern contract law is not that different from Roman law and that the substantive justice preserved by Aristotelian tradition is still protected by courts universally to prevent unfair outcomes.⁴¹ In his view, courts across the board in both civil and common law jurisdictions gave relief to one-sided contracts through devices such as *lésion*, usury, and unconscionability.⁴²

Following Aristotelian tradition, Gordley made a strong argument that contracts reached at a price other than the fair market price are all entitled to relief.⁴³ The reasons that remedies given for unfair prices are less often than one would expect are that (1) one is allowed to have the liberty to confer

³⁵ See *id.* at 405.

³⁶ *Id.* at 408.

³⁷ See generally CODE CIVIL [C. CIV.] [CIVIL CODE] ART. 1134 (noting that “contracts legally formed have the force of law for the parties who made them.”); see also Contract Law of the People’s Republic of China, *supra* note 3 (noting that “parties have the right to lawfully enter into a contract of their own free will in accordance with the law, and no entity or individual may illegally interfere therewith.”).

³⁸ GORDLEY, *supra* note 25, at 214.

³⁹ ATIYAH, *supra* note 30, at 404.

⁴⁰ See *id.* at 422.

⁴¹ See Gordley, *Equality in Exchange*, *supra* note 1, at 1656.

⁴² See generally *id.* at 1587.

⁴³ See generally *id.*

benefit to the other party through contracting,⁴⁴ (2) the fair market prices change constantly to reflect the need, cost and scarcity of the goods so the price that seemed unfair after contracting might be fair upon conclusion- a fair bet at price fluctuation is fair,⁴⁵ and (3) it might not be economical for the victim to seek to remedy every unfair price when the damage was small.⁴⁶

The unrestricted role that the rise of capitalism and 19th century liberalism played on the will has undoubtedly declined as Grant Gilmore and Atiyah have observed.⁴⁷ According to them, the destiny of freedom of contract is closely related to that of general theories of contract law, and, in common law, neither of the two existed before the 19th century.⁴⁸ The role of freedom of contract has declined, while the dominant role of the general theory of contract has gradually given way to the protection of consumer interests in transactions where the bargaining powers are extremely unequal, limitations placed on adhesion contracts, the emergence of regulatory law, and sophisticated commercial contracts that will allow parties to opt out of the free bargaining requirements that one would expect from any contract law regime.⁴⁹

Still, in the West, as in most parts of the world, freedom of contract as a doctrine survived these attacks and is widely respected outside the particular limitations mentioned. The resilience of freedom of contract, as a doctrine, comes from the consensus that it is of great value in most societies to allow self-determination in a market economy. Nevertheless, each society finds ways to limit freedom of contract to prevent exploitations of the less informed parties. From Roman law to the contemporary contract law practice, fairness of contract prices always plays a role in deciding whether relief shall be given. The less informed parties may be the shareholders who could not evaluate the contract concluded by the board of directors due to information asymmetry, or a person induced to contract by fraud, duress, or undue influence. In both circumstances, the fairness of prices matters. For example, consider American law governing a fiduciary relation. When the presumption of breach of duty of care is raised, the defendant fiduciary can prove he has met the duty of care by showing the transaction was entirely

⁴⁴ See *id.* at 1652.

⁴⁵ See *id.* at 1613.

⁴⁶ See *id.* at 1654.

⁴⁷ See generally GRANT GILMORE, *THE DEATH OF CONTRACT* (1974); See also ATIYAH, *supra* note 30.

⁴⁸ See *id.*

⁴⁹ For example, in commercial service contracts, the more sophisticated party often opts out the law in the jurisdiction where the service is rendered through forum selection clause, which was not a result of free bargaining.

fair. Entire fairness includes a fair price and fair dealing. An unfair price alone provides a ground for judicial review; the courts will determine whether the transaction was substantively fair by examining the economic and financial considerations.⁵⁰

B. The Merits of Freedom of Contract and its Incompatibility in China

There are two major views that justify freedom of contract: the moral view and the utilitarian view. However, when neither private ownership nor free and competitive market exists, neither of the two views can justify freedom of contract.

According to the moral view, freedom of contract reflects the progress of society and the social movement from status to contract.⁵¹ People began to “determine themselves and their own life styles by entering into contracts.”⁵² Safeguarding one’s power of self-determination and freedom to act as he chooses became the primary task of a legal system. The idea behind freedom of contract is that “a person in possession of legal capacity, not influenced by mistake or undue pressure, is fully capable of determining his fate as far as legal relationships of private law are concerned.”⁵³

According to the utilitarian view, the society benefits when an arrangement mutually agreed upon is held to be binding. A reasonable person knows his interest better than anyone else, and will only contract when he knows that he will benefit by doing so. Allowing every participant to contract freely allows everyone to benefit, and so allows the society to benefit.⁵⁴

However, neither moral nor utilitarian advantages could have been deemed relevant in the traditional pre-reform Chinese economy.

The moral merits of free contracting could not be relevant. In post-1949 Chinese society individuals were not legally allowed to contract until 1999 and, at the enterprise level, SOE managers entered into contracts on behalf of the state to achieve the state’s objectives rather than their own.

⁵⁰ Thomas A. Uebler, *Reinterpreting Section 141(e) of Delaware’s General Corporation Law: Why Interested Directors Should Be “Fully Protected” in Relying on Expert Advice*, 65 BUS. L. 1023, 1028 (2010).

⁵¹ HENRY SUMNER MAINE, *ANCIENT LAW: ITS CONNECTION WITH THE EARLY HISTORY OF SOCIETY AND ITS RELATION TO MODERN IDEAS* 165 (1864).

⁵² See KONRAD ZWEIGERT & HEIN KOTZ, *INTRODUCTION TO COMPARATIVE LAW* 325 (3rd rev. ed., Tony Weir trans., Clarendon Press, Oxford 1998).

⁵³ BASIL S. MARKENSINIS ET AL., *THE GERMAN LAW OF CONTRACT: A COMPARATIVE TREATISE* 45 (2nd ed. 2006).

⁵⁴ See ZWEIGERT & KOTZ, *supra* note 52, at 326.

Furthermore, without a competitive market, a manager was not responsible for the financial consequences arising out the contracts concluded by him on behalf of the state. Moreover, he had no right to determine the contents of contract, when and whether to terminate the contract, or the form of the remedy. As a result, nobody determined his own fate by contracting.

In China, when the managers of SOEs did not share the ownership interest or receive a performance bonus based on the profitability of the SOEs, their personal interest was incompatible with the state's ownership interest. Allowing freedom of contract would have encouraged the managers to engage in opportunistic contracting that benefited themselves rather than the state. Therefore, allowing freedom of contract among Chinese SOEs was inconsistent with the individual autonomy or public interest that freedom of contract promotes.

Contract law certainly predates capitalism and will theories. Principles such as equality in exchange, commutative justice, and fairness guided contractual transactions in pre-commercial societies and post commercial but pre-capitalist civil law.⁵⁵ In view of the difficulties mentioned earlier, one must ask whether every industrialized society must have contract theories that are based solely on the will and autonomy. Does the principle of freedom of contract apply to any human society regardless of the particular features in its economy, or are there certain prerequisites for this doctrine to be justifiable?

Admittedly, it has been pointed out that the history of freedom of contract is also the history of its limitations.⁵⁶ Also, it is true that freedom of contract has become an unattainable ideal in Western society just as it is in societies such as China where private ownership and competitive markets are absent. One might doubt the value and utility of comparative law scholarship made that compares the freedom of contract in Western societies and China when freedom of contract has become an unobtainable ideal in virtually all societies and, as in the West, China has declared its compliance with international standards by making freedom of contract a fundamental principle in its contract law statute.

Nevertheless, this situation is not a distinction without a difference. At least, the causes of difficulties in applying freedom of contract as a doctrine are different. Chinese and Western law may seem to converge as central economic planning no longer serves as the only means in the allocation of

⁵⁵ See generally Gordley, *supra* note 26, at 2-23, 2-24.

⁵⁶ 韩世远 [HAN SHIYUAN] 合同法总论 [GENERAL THEORIES OF CONTRACT LAW] 38-39 法律出版社 (Law Press 2011).

commodities in China, and *laissez-faire* capitalism has lost its charm in the West. Still, the fact that the autonomous rights in contracting among Chinese SOEs are still limited compared to the Western counterparts creates a distinction.

In the West, freedom of contract served to boost the free and competitive market economy. As a result, big corporations arose which destroyed the freedom of bargaining. Paternalistic government interventions became necessary to remedy the extremely unequal bargaining power. Their goal was to restore freedom of contract and free bargaining to best possible extent. As an ideal, freedom of contract is still desirable in the West. Paternalistic measures are put in place to annul standard form clauses, and to reconstruct the terms the weaker party would have agreed to.

In China, freedom of contract was not and is not desirable given the endogenous features of Chinese SOEs. When examining the economic history of the birth of freedom of contract, one can see the social and economic conditions during the industrial revolution that warranted the emergence of freedom of contract. They include private ownership of business, free and competitive markets, individualism, and the triumph of the will theories. These conditions did not exist before the Chinese economic reform and are still limited by the paternalistic features of Chinese economy three decades afterwards. As a result, the adoption of freedom of contract does not bring about the same desirable effects as it had produced in the West. Instead, in China, freedom of contract will intensify the moral dilemmas Western courts have faced. Consequently, differences in contract law can be justified for good reasons and will not be eliminated without massive privatization and introduction of a free and competitive market in the Chinese economy. To understand such differences, one has to start with the economic logic that justified the trinity of Chinese traditional economy: centralized allocation of resources, price distortion and micromanagement of the SOEs.⁵⁷

III. THE LOGICAL STARTING POINT: THE DENIAL OF THE PRIVATE ECONOMY

A. *The Economic Logic in the Establishment of SOEs*

Upon the founding of the communist regime in 1949, the government realized the development of heavy industry as a priority in national economy for China if it were to survive the economic embargo and military

⁵⁷ See JUSTIN YIFU LIN ET AL., *THE CHINA MIRACLE: DEVELOPMENT STRATEGY AND ECONOMIC REFORM* 59 (Rev. Ed., The Chinese University Press, 2003).

threats imposed by the West.⁵⁸ With a backward agrarian economic structure and a labor-abundant but capital-scarce economy, it was essential to be able to channel the limited capital available into heavy industry while suppressing the prices of products and other factors indispensable for the heavy industry, such as raw materials, labor, services, energy, and agricultural products.⁵⁹ Also, industrial residues from other industries needed to be maximally channeled into the heavy industry.⁶⁰ Because private investors would have more incentive to invest in the service industries where abundant labor can be used at bargain prices, it was economically logical for the government to nationalize heavy industry and establish state-owned enterprises to carry out state objectives regardless of financial profitability. Sectors outside the heavy industry were nationalized to lower the cost of resources needed for heavy industry. Such resources were channeled into heavy industry at below market prices. Such an allocation of resources would not have prevailed if these sectors were in the hands of private investors.⁶¹

It logically follows that, after the thorough nationalization, private sector was eliminated and the state owned every single business. Only legal persons (state-owned enterprises, government agencies, and village collectives) were allowed to contract.⁶² The free market was replaced by a pure supply system. When there was no market, and the sole purpose of industrial production was to carry out state economic plans, there was a natural incompatibility in the incentives to serve state objectives and those of the SOEs. In a competitive market, profitability is the most effective information indicator for managerial performance. It is a checks and balances mechanism that holds managers accountable for their performance. When a market does not exist, the owner of the SOEs, the state, has no equally effective indicator to evaluate the performance of SOE managers. Without a market, profit and loss no longer reflect managerial performance.

⁵⁸ See LIN, *supra* note 16, at 21.

⁵⁹ See *id.* at 20-28.

⁶⁰ See *id.*

⁶¹ Heavy industry itself is capital-intensive and the price to use limited capital in a poor country like China was extremely high. The threshold would have been much lower and the investment much more profitable to invest in light industry rather than heavy industry. In 1957, profit and tax generated by the same capital in light industry was 270 percent than that in heavy industry. If a free and competitive market was available for private investors, there would have been a much lower incentive for the investors to channel their capital into the heavy industry. In addition, if resources were allocated through a free market, it would have been too expensive to realize the rapid growth when the prices of capital and raw materials, labor and energy were at their fair market prices. See *id.* at 21-22.

⁶² See 关于工矿产品订货合同基本条款的暂行规定[The Tentative Rules on Industrial and Mining Products Ordering Contract] art. 3 (1963) (China).

In an economy with such serious price distortion as that of pre-reform China, price did not reflect the scarcity of resources. The profit level could be heavily influenced by state economic policies. Since it was unlikely to hold SOE managers financially accountable, when managerial or contractual autonomy was allowed, SOE managers tended to reward themselves by retaining more profits and raising wages, which conflicted with the state agenda that called for rapid development of the heavy industry at the lowest cost. In addition, the personal stakes SOE managers as career bureaucrats had in the operation of SOEs were disproportionate to the potential losses state might suffer from opportunistic deviation from state plans.

In the West, it is the incentive divergence rather than incentive incompatibility that corporate law theories work to reduce. The premise of the theory is that when one person exercises authority that affects another's wealth, interests may diverge. Business managers, as the agents of the investors, always have divergent interests from the investors. Such a divergence exists in any agency relation.⁶³ The smaller the share of ownership that the managers hold, the larger the divergence of interest becomes. For example, the manager will not have the same level of incentive to make an extra effort to increase the profit of the enterprises as the investors themselves would have if their own share of ownership is small and the increase of their own wealth is small compared to their extra efforts.⁶⁴

In the Western free market and free enterprises system, such a divergence can be controlled in three ways:

- 1) There is the employment market: an unfaithful or indolent manager may be penalized by a lower salary, and a diligent one rewarded by a bonus for good performance. This is function of incentive-compatible contracts- that rewards managers for good performance and penalize them for bad. The goal is to align the interests between managers and shareholders as closely as possible.

- 2) The threat of sales of corporate control induces managers to perform well in order to keep their positions.

⁶³ FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 91 (Harvard 1991).

⁶⁴ *See id.*

3) Competition in product markets helps to control agents' conduct, because a poorly managed firm cannot survive in competition with a well-managed firm.⁶⁵

However, these mechanisms reduce but cannot eliminate the divergence of incentives. Consequently, principles of fiduciary duty are used to avoid direct and extensive monitoring and elaborate internal contracting that would allow the investors to evaluate the managerial performance. Managers are allowed to exercise managerial discretion, but will be held accountable for the negative managerial conduct that violates the requirements of fiduciary duty. Therefore, the business judgment rule controls. The rationale behind this rule is the recognition that investors' wealth would be lower if manager's decisions were routinely subjected to strict judicial review.⁶⁶

In China, before the economic reform, SOE managers, if given the managerial and contractual autonomy permitted by the American business judgment rule, would have tended to maximize the profits of the enterprises or avail themselves of the industrial surplus, neither of which was consistent with the state's objective to prioritize the heavy industry. Therefore, the purpose of SOEs for the state, as the sole investor in SOEs, was to implement its economic plans rather than to use the SOEs to maximize its wealth. SOE managers were instructed to adhere strictly to economic directives and orders. Logically, it made sense that SOE managers should not be accountable for the profitability of the SOE. As a matter of fact, SOEs' business operations often resulted in heavy deficits. When the profit-motive was not permissible, managers tended to intercept the industrial residual and to misappropriate state assets, if any managerial autonomy was afforded to them. Such an incompatibility could not be cured by negotiating incentive-compatible contracts between state and SOE managers through the employment market simply because managers had no ownership interest in SOEs. The direct result was that the incentives between the two were opposed. Again, there were no employment markets for corporate executives since all the managers were government employees at the same time. Also, SOE managers could be laterally transferred to other government positions. Finally, a poorly managed firm could still survive when there was no market available to push it out.

As contractual and managerial autonomy could not be justified, it was necessary for the state to supervise every aspect of the business operation to make sure the state economic plans and objectives received priority over the

⁶⁵ See *id.*

⁶⁶ See *id.*

individual agenda of an enterprise itself. Before the economic reform, at the enterprise level, SOEs did not have production decision-making autonomy.⁶⁷ SOEs could not decide what to produce, their research and development direction, or how much they were going to produce.⁶⁸ In order to negate the incentive for profit maximization, SOEs did not have independent budgets and would not be held accountable for deficits. All the deficits had to be absorbed by the state and virtually all the profits were turned over to the state as well.⁶⁹ For the same reasons, SOEs could not set employee wages on their own. Moreover, autonomy in resource allocation was taken away from SOEs. When allocation of resources was not completed through the market and prices of the raw materials were artificially suppressed, prices no longer reflected the scarcity of the resources. If SOEs were allowed autonomy to decide what resources they needed and how much was needed, every SOE would have the incentive to acquire more resources at suppressed prices by increasing the cost of production.⁷⁰ As a result, each enterprise would submit a proposal to the material supply agency within the government describing the resources and materials needed to complete the mandatory plans assigned by the state. The government would deliver the materials, once the proposal was approved, based on the state economic plans.⁷¹ The SOEs did not have the autonomy to select suppliers or compare the products.⁷²

Consequently, instead of the decentralization of business decision making in the West, in the pre-reform Chinese economy, the state had to give specific directives to individual enterprises on the types of products to be manufactured, the quantity, quality, and specifications of the products, the kind and quantity of the raw materials an enterprise received, the pricing and the buyer of the products, and the wages of labor and management. Any unauthorized reselling of products and sale of unauthorized products would result in the nullity of a contract, along with civil and criminal sanctions. Contract management was strictly carried out by various ministries, departments and economic commissions at all levels of the government.

B. *The Theoretical Coherence of Socialist Contract Law*

Intellectual efforts had been made by socialist jurists to piece together coherent contract theories that would support the planned economy.

⁶⁷ LIN, *supra* note 16, at 32.

⁶⁸ *See id.*

⁶⁹ *See id.* at 33.

⁷⁰ *See id.*

⁷¹ *See id.* at 37-38.

⁷² *See id.* at 38.

According to the theorists, ownership of the means of production was exclusively in the hands of the state.⁷³ Even means of subsistence, the resources necessary for people's daily consumption, could not be traded on the market.⁷⁴ The only interest protected in contracting was the state's interest. The institution of contracts served as an important tool in ensuring the implementation of state plans.⁷⁵ Contracting connects the enterprises systematically and helps to clarify and determine the content of state plans.⁷⁶ Since no private interest is involved, all the contracting parties were simply executing orders from the state. Therefore, the contracting parties were to collaborate and supervise each other throughout the performance of contract to carry out the state's agenda.⁷⁷ A party who defaulted was liable for penalties and damages. Any deviations from the plan would result in the illegality of the contract. The only overlap between the state and private sector lay only in the uniformed procurement and supply where prices were set by the state.⁷⁸

The *1958 Civil Law textbook* ("the Treatise"), presented a coherent socialist contract theory. In the Treatise, even though freedom of contract was criticized for its lack of legality, contractual autonomy was not entirely denied.⁷⁹ The Treatise proposed that the principle of voluntariness and reasonableness be the fundamental principle of contract law.⁸⁰ However, the Treatise stressed that contracts should be entered for the sole purpose of implementing state plans and where state and individual interests coincided.⁸¹ According to the Treatise,

⁷³ The leading treatise at the time, known as the 1958 Civil Law Textbook, pronounced that the elimination of capitalist ownership was completed through public private joint venture and the petit private ownership of peasants and craftsmen were gradually eased out through their "voluntary participation in the rural cooperatives." As a result, private ownership of means of production had ceased to exist. See 中央政法干部学校民法教研室 [Teaching and Research Section of the Central Political and Legal Cadres' School, ed.] 中华人民共和国民法基本问题[BASIC ISSUES OF CHINESE CIVIL LAW] [hereinafter, *The Treatise*] 26 (Beijing: Law Press, 1958).

⁷⁴ The rationale was that private means of subsistence was protected but could not in any way abuse means of subsistence to harm public interest or exploit others. See *id.* at 129.

⁷⁵ *Id.* at 26.

⁷⁶ *Id.* at 27.

⁷⁷ See discussion *infra* Section IV.B.

⁷⁸ 梁慧星 论我国合同法律制度的计划原则与合同自由原则 《法学研究》1982年第4期 第44页 [Liang Huixing *On the Plan Principle and Principle of Freedom of Contract in Our Contracting System*, Legal Studies Vol. 4, 44 (1982)].

⁷⁹ See generally *The Treatise supra* note 73.

⁸⁰ See *id.* at 202.

⁸¹ *Id.*

[c]ontracting should follow parties' voluntariness and its conclusion must be based upon the free declaration of wills, sufficient mutual negotiations, and the meeting of minds. Neither party is allowed to impose its will on the other by ordering the other party to accept its opinion or other illegal means through the conclusion of contract.⁸²

Furthermore, reasonableness requires that

the content of a contract must be fair and reasonable so that neither party's interest is harmed, neither could the contract harm public and social interest. The whole or part of a contract shall be annulled if the content of the contract was obviously unfair or unreasonable.⁸³

The content of these two requirements resembles the Western view of freedom of contract and its limitations. Classical contract theory gave wills of the contracting parties binding force barring illegality and immorality or violation of public policies.⁸⁴ It was also not unusual for devices such as *Wucher* in German law, *lésion* in French law, and unconscionability in common law to cure unfair prices. It was said in China that prices of commodities in the West were determined by Marx's law of value, which guided the circulation and production activities in the society.⁸⁵ However, in the view of the Treatise, the unavoidable phenomenon of price fluctuation in the West was used as a means by capitalists, the only class that owned means of production, to exploit toilers by engaging in opportunistic behaviors. China, on the contrary, by establishing the socialist economy, limited the effectiveness of the law of value.⁸⁶ Through careful planning, the state supposedly would be able to set the prices of commodities differently from its values. Such differences were being used consciously to "adjust the circulation of commodities" with the purpose of "improving the quality of toilers' material and cultural lives."⁸⁷

However, the Treatise argued that the difference between principles of voluntariness and freedom of contract lies in that freedom of contract emphasized voluntariness while neglecting the requirement of legality.⁸⁸ The voluntariness principle, according to the Treatise, allows contracting parties to freely express their wills provided but only within the scope

⁸² *Id.* at 203.

⁸³ *Id.*

⁸⁴ See ZWEIGERT & KOTZ, *supra* note 52, at 381.

⁸⁵ See *The Treatise*, *supra* note 73, at 217.

⁸⁶ See *id.*

⁸⁷ See *id.*

⁸⁸ See *id.* at 204.

permitted by law.⁸⁹ For example, in a sales contract, elements such as the object and the range of the prices must be prescribed by law.⁹⁰ Capitalist law was criticized as permitting unlimited autonomy in contracting, which allowed the owners of means of production unlimited exploitation of the toilers.⁹¹ Allowing free contracting without setting the variety and price of commodities would result in monopoly, at which point, contract terms would no longer be negotiated.⁹² Toilers then only have the options of accepting the terms or refusing to contract. This meant allowing exploiters the freedom of exploitation without letting the toilers have the freedom not to be exploited.⁹³ Therefore, only in the communist regime, would toilers be free from exploitation. According to Mao Zedong, when bourgeois class had its freedom, there would not be freedom for proletariats.⁹⁴ The Treatise concluded that principle of voluntariness is a unification of freedom and discipline where “proletarians enjoy a wide range of freedom but restrain themselves through socialist discipline.”⁹⁵

Transactions between individuals in the shadow economy were deemed illegal but could not be regulated otherwise since law does not allow transactions between private parties. Outside the shadow economy, the only transactional relationships between the state and private parties were the procurement of products from the state and supplies of commodities to the individuals. In such circumstances, no competition between the state and private interests existed and the state did not have to play contradictory roles as a referee and a player at the same time, the roles it now plays in the post-reform economy. The issues with the state invasion of private interest by allowing SOEs to back out of a bad bargain with a private party did not exist. Also without private ownership and a market, courts would not have to face the theoretical difficulties as to whether to observe the external formalism as freedom of contract would require and restrain themselves from reviewing the substance of the contract. Courts would always be able to annul a contract where a state interest of any sort was jeopardized.

⁸⁹ *See id.*

⁹⁰ *See id.*

⁹¹ *See The Treatise, supra* note 73, at 204.

⁹² *See id.* at 204-205.

⁹³ *See id.* at 205.

⁹⁴ 毛泽东 [Mao Zedong] 《关于正确处理人民内部矛盾问题》 [On How to Handle the Internal Conflicts among the Masses] (1937).

⁹⁵ *The Treatise, supra* note 73, at 206.

Therefore, theoretical coherence of socialist contract law was achieved regardless of its limited practical application.⁹⁶

IV. THE RISE OF FREEDOM OF CONTRACT IN CHINA AND ITS LIMITATIONS

A. *The First Round of the Economic Reform*

Given the poor efficiency and the shortages caused by the pre-reform economic structure, the Communist Party leadership reached a consensus that this structure was not sustainable. In contrast to the later reforms in the socialist regimes in Central and Eastern Europe, China reformed its SOE sector without privatizing it and allowed a private sector to emerge outside the state sector.

Since the beginning of the economic reform at the end of 1970s, efforts had been made to cure the inefficiency and insensitivity of the State-run economy. More autonomy and incentives were given to the State-owned enterprises while at the same time, a private sector opened up to legalize the existence of non-SOEs. Rural peasant households and urban individual business households were prime examples of the emergence and growth of the private ownership. Private enterprises, Township Village Enterprises, and foreign invested enterprises (“FIEs”) grew at remarkable rate. The share of SOEs in industrial output fell from over 80% to below 60% in 1988, and to below 30% in 1997.⁹⁷ In 2002, less than 15% of the enterprises were SOEs. At the beginning, SOEs were allowed to retain certain percentage of profits above the quota, which created the incentive to make profits. Later, SOEs were allowed to negotiate detailed performance contracts with the government that allowed operational and contractual autonomy in enterprises.⁹⁸ Moreover, SOE employees no longer had tenure employment and their performance was linked with the performance.⁹⁹ The economic reform, with continued dominant state ownership in business to pursue non-business driven goals and the absence of a free and competitive market, improved management efficiency, but created the theoretical incoherence. This is because the changes do not cure the pre-existing problems of incentive incompatibility, information asymmetry, and liability disproportionality, which were the very reasons for the denial of contractual autonomy and incentive to maximize profits. SOEs continue to operate

⁹⁶ The Socialist contract theory does not have practical application to shadow economy or any contractual transactions that do not involve state or state-owned enterprises.

⁹⁷ See SHAHID YUSUF ET AL., UNDER NEW OWNERSHIP: PRIVATIZING CHINA’S STATE-OWNED ENTERPRISES 60 (2006).

⁹⁸ See *id.* at 59; see also LIN, *supra* note 16, at 54-56.

⁹⁹ See YUSUF, *supra* note 97, at 56.

based on goals that are not business driven, resulting in practices such as overstaffing to reduce urban unemployment rates, or selling essential products at prices well below fair market value.

When managers are not accountable for their financial performance due to the absence of a reliable indicator by which performance can be evaluated, allowing SOE managers the same level of contractual autonomy that freedom of contract will permit them will not produce the same utilitarian effects as in the West. They are not bearing the negative consequences of their decisions, and the incompatibility of the incentives that motivate them cannot be reduced or controlled by the fiduciary duty principles.

Over a decade after the SOE reform, the results were conflicting and improvement in efficiency stalled. In 1995, 44% of SOEs were operating in deficit.¹⁰⁰ Legal reform took place to adapt to the new economic conditions. The Economic Contract Law (“ECL”) was enacted in 1981 to recognize the rights and interests of contracting parties. The parties’ wills were respected when they did not conflict with laws, public policies and state economic plans. Still, contracts were closely monitored by the state to prevent entrepreneurial opportunism because when the law was enacted virtually all contracting parties were SOEs. The forms that a contract must take and the terms that must be included are stipulated in the Economic Contract Law. Also, the violation of state economic plans results in the nullity of a contract. Moreover, such a contract was deemed void, not voidable, and so the contracting parties did not have the option of choosing not to avoid it. Safeguards to ensure transactional safety in the West, such as the doctrines of apparent authority and *ultra vires*, were deemed illegal mainly to prevent SOE managers’ opportunistic attempt to maximize the profits.

As cases decided in this period will show, any autonomous business conduct such as the purchase of unauthorized products, the resale of purchased products at a higher price, or the sale of products to unauthorized purchasers would result in the nullity of the contract and civil and economic sanctions. No matter how ridiculous these decisions might appear in the eyes of Western lawyers, illegality and violation of public policy are universally recognized as grounds on which a contract is void. Moreover, because virtually all business entities allowed to contract at that time that the ECL was enacted were owned by the state, no private interest could have been harmed by nullifying all contracts. At the beginning of the economic reform, private parties were simply not within the purview of the ECL.

¹⁰⁰ See LIN, *supra* note 16, at 66.

B. *The Guiding Cases*

In the 1980s, several collections of economic contract cases were published by government authorities and served as guidance for courts at all levels in deciding economic contract cases. The description in this study of how the ECL was interpreted in the 1980s is based on an analysis of 50 cases included in one of these collections entitled *An Analysis of Economic Contract Cases*.¹⁰¹ These cases were decided between 1979 and 1986. Virtually all contracting parties in the collection were SOEs, with the exception of individual business households.

China has always followed the civil law tradition, which officially denies that cases have the authority of *stare decisis*. Unofficially, however, these cases played a significant role in forming a coherent practice in contract law nationwide. Courts do consult guiding cases from the case collections and the gazettes of the people's courts in making decisions, even though there was no uniform case reporting system, and courts have never been allowed to cite cases. The absence of a civil code made these cases even more influential as judges did not have a legal source more authoritative than the collections. In addition, the case collections also provided official comments that either explained the rationale behind the court decisions or pointed out the mistakes the courts made in interpreting the law.

As we have seen, more managerial and contractual autonomy was given to SOE managers. However, when a competitive market and private ownership rights in SOEs were still lacking, one of the main problems the post-reform system had to deal with was preventing SOE managers' opportunistic behavior to encroach upon state interest or to strip state assets through self-dealing. A large proportion of the cases had to deal with illegal profiteering by SOEs through resale, *ultra vires* activities outside their scope of businesses, or the apparent authority of an agent who tried to bind the SOEs. This was why the Western doctrines of *ultra vires* and apparent authority were not recognized in China. As we have seen, profiting by resale was illegal and could be penalized.

On the other hand, courts in several cases emphasized the binding force of a contract voluntarily entered into, which changed the pre-reform

¹⁰¹ See WANG ZONGHUA & YIN HONGFENG (王宗华 殷红峰), JINGJI HETONG JIUFEN ANLI XUÄNBIAN (经济合同纠纷案例选编)[Selected Cases on Economic Contract Disputes] (1987) [hereinafter "The Collection"]; see also Roderick W. MacNeil, *Contract in China: Law, Practice, and Dispute Resolution*, 38 STAN. L. REV. 303, 307 (1986). It was said that the collections on economic contract cases were the very first collections of cases in any field in Chinese law.

paradigm where parties did not care whether a contract was enforced, and the performance of a contractual obligation depended on the ability of the obligor and the relationship between the managers of the two contracting enterprises.¹⁰²

Also, courts were entrusted with minimizing the harmful effects of contracting to the collective system. As a result, courts decided the cases based on the principles of loss splitting between the parties and reciprocal accommodation of each other's difficulties.

i. Who May Contract

Courts made it very clear that only legal persons were allowed to enter a contract, and the only entities that qualified as legal persons were SOEs. In a 1986 case, the court declared a sales contract of 5,000 color TVs at RMB 1,500 yuan per TV null and void when the defendant-seller defaulted and the plaintiff-buyer brought the suit to enforce the contract.¹⁰³ The contract was entered by the industrial company affiliated with the municipal bureau No. 1 and the materials supply station of the municipal bureau No. 2. The main reason for annulment was that neither party was considered a legal person and therefore neither was allowed to enter into economic contracts. The reason was probably because the affiliations of these two companies made them a branch office of government agencies and so deprived them of the independent status as legal persons. In addition, since neither apparent authority nor agency by estoppel was recognized in China at that time, it was impossible to bind the superior government agencies with which they were affiliated. In addition, selling color TVs was outside their scope of business. The second ground for annulment was profiting through resale.¹⁰⁴ According to the investigation conducted by the court, these Toshiba Color TVs came originally from state foreign trade agencies, who sold the TVs at RMB 1,200 yuan to the supplier, a government designated retailer.¹⁰⁵ The supplier should have been selling the TVs to the general public rather than reselling the TVs.¹⁰⁶ However, the supplier sold the TVs to a department store at RMB 1,300 yuan per set. After a few rounds of reselling, this contract was concluded at the price of RMB 1,500 yuan. According to the court, such opportunistic buying and reselling was illegal. Not only was the contract annulled, both parties were fined. In

¹⁰² See POTTER, *supra* note 15, at 28.

¹⁰³ The Collection, *supra* note 101, at 3.

¹⁰⁴ See *id.*

¹⁰⁵ See *id.*

¹⁰⁶ See *id.*

addition, the illegal gains obtained by every entity on the supply chain were confiscated.¹⁰⁷

In another case, a contract was deemed absolutely null when one of the contracting parties was not a legal person. The contract in dispute was over an earthwork construction contract between a general contractor, the No. 1 Municipal Construction Company of City A, and a subcontractor, the No. 2 County Construction Company of Province B.¹⁰⁸ The general contractor won the bid for an earthwork construction project and assigned the No. 5 construction brigade under it to undertake the project.¹⁰⁹ However, the brigade subcontracted the entire project to the subcontractor at a rate lower than the budget quota issued by the municipal Construction Committee.¹¹⁰ The subcontractor soon found out that the price offered was not sufficient to finish the project so it asked to rescind the contract, and the general contractor agreed.¹¹¹ The general contractor later sued the subcontractor attempting to have the contract enforced.¹¹² Surprisingly, the court did not annul the contract on the grounds that the subcontract was illegal but only held that the No. 5 brigade, as a non-legal person, was not qualified to enter into an economic contract.¹¹³ Therefore, not only was the contract null, but the plaintiff had to bear all the damages and court costs.¹¹⁴

Though more information is needed to fully appreciate the court's decision, it may be suspected that the contract was concluded under the seal of the brigade rather than that of the construction company. Therefore, the contract was annulled for the want of the official seal of a legal person. Only the construction company qualified as a legal person, not the brigade under it. It was clear that the contract was agreed upon between the two construction companies who were both considered legal persons. The court used this technicality to annul the contract rather than rely on the ground of violation of the pricing regulation. According to the official comment, the plaintiff's subcontracting activity should be condemned.¹¹⁵ Again, we see opportunistic behavior of SOEs in maximizing their profits. Such conduct would not be common in the pre-reform regime when SOEs had to turn over all of the profits and state would absorb all the deficits. In 1992, a departmental rule issued by the Ministry of Construction officially outlawed

¹⁰⁷ *See id.* at 4.

¹⁰⁸ *See id.* at 5.

¹⁰⁹ The Collection, *supra* note 101, at 5.

¹¹⁰ *See id.*

¹¹¹ *See id.* at 6.

¹¹² *See id.*

¹¹³ *See id.*

¹¹⁴ *See id.* at 7.

¹¹⁵ The Collection, *supra* note 101, at 7.

such subcontracting where the general contractor assigned the entire contract to a subcontractor without assuming any supervisory responsibilities but charged a management fee.¹¹⁶

As an exception to the legal person requirement, courts have held that individual business households and members of rural agriculture communes could enter into economic contracts with legal persons.¹¹⁷ This exception was also recognized in the miscellaneous provisions of the ECL.¹¹⁸ The official comment in the collection explained that “individual business households refer to individually-run businesses in the industries of handicraft, retail, dining and service etc. Such individual businesses were supplement to the socialist public economy. Their lawful interests are protected by the state law.”¹¹⁹

ii. Strict Prohibitions Against Ultra Vires and Apparent Authority

As we have seen, when prices were not liberated and a competitive market did not exist, many kinds of opportunistic conduct were pursued. SOE managers attempted to reward themselves by taking advantage of the difference in pricing between state plans and the market, by trading the resources they were authorized to buy and sell with the resources they were not authorized to, or by encroaching on state interest whenever they acquire any autonomous rights. Therefore, any expansion of the designated autonomous rights or delegation of any authority is prohibited from harming the collective system. As we will see, courts denied both *ultra vires* activities and the ECL itself prohibited the exercise of apparent authority and annulled the contracts entered outside the scope of agency.

a. The Denial of Apparent Authority

In a 1984 case, a hospital refused to accept several shipments of medical instruments delivered to them and to pay for them according to four

¹¹⁶ 工程总承包企业资质管理暂行规定 [Provisional Rules on the Qualifications of Construction General Contractor Enterprises](promulgated by the Ministry of Construction, effective 1992), Act No. 189/1992 (China).

¹¹⁷ See The Collection, *supra* note 101, at 78.

¹¹⁸ See 中华人民共和国合同法 [Economic Contract Law of the People's Republic of China](promulgated by the National People's Congress, Dec. 13, 1981, effective July 1, 1982) 1981 STANDING COMM. NAT'L PEOPLE'S CONG. GAZ 12 (amended 1997), Art. 54 [hereinafter Economic Contract Law].

¹¹⁹ The Collection, *supra* note 101, at 79.

sales contracts they appeared to have entered into with the manufacturer.¹²⁰ Again, both parties were state-owned enterprises. According to the court's investigation, it turned out that four contracts were executed by a hospital staff member posing as an agent of the hospital. He entered contracts on behalf of the hospital and his identity was verified by the seal of the hospital general affairs office that he carried with him and used to contract.¹²¹ Two of these contracts were affirmed by the hospital while the other two were entered without the leadership and a legal representative of the hospital knowing.¹²² The manufacturer had no reason to know that the staff member of the hospital did not have the authority to conclude the latter two contracts. The court affirmed the validity of the first two contracts, but held that the two later contracts were void because they were not entered by the legal representative of the hospital, and the seal used was not the hospital seal, which was the only valid seal for contracting purposes.¹²³ The official comment criticized the hospital for its mismanagement in entering into the void contracts while also criticizing the plaintiff was also at fault for not verifying the agent's identity.¹²⁴ For that reason, the court costs were borne by both parties.¹²⁵ The comment claimed that the unauthorized agent alone should bear all the damages. Since the collective economic system would be at loss if the products manufactured were not wanted, as a result, under the court's mediation, the hospital was willing to pay for the two valid contracts in full and 90% of the contract price of the two invalid contracts.¹²⁶ The comment admitted that according to the ECL when a contract is annulled, property received through contract should be returned. Nevertheless, the court-supervised mediation was commended because the court recognized that the medical instruments in dispute were needed by the hospital anyway and so it encouraged the parties to reach a new sales contract.¹²⁷ The behind-the-scenes rationale of the decision was to minimize the loss of the state. This is because the only party who suffered the loss would be the state if the manufactured goods were not needed. The principle is that such loss suffered by the state should be minimized and shared by SOEs.

In a 1982 case that occurred just before the ECL took effect, a merchandiser of a Beijing chemical plant fertilizer (the buyer) was sent to purchase conductive tapes from a Hebei province manufacturer.¹²⁸ The

¹²⁰ *See id.* at 10.

¹²¹ *See id.*

¹²² *See id.*

¹²³ *See id.*

¹²⁴ *See id.* at 12.

¹²⁵ The Collection, *supra* note 101, at 12.

¹²⁶ *See id.*

¹²⁷ *See id.*

¹²⁸ *See id.*

sourcing agent was not aware of the specifications of the tapes the principal asked for when he made the order, and therefore ordered the wrong type of tapes.¹²⁹ The contract terms were based on mutual consultations.¹³⁰ However, when the manufacturer was manufacturing the tapes they were not sure about the length of the diameter for the end.¹³¹ The contract said the length should be 8mm.¹³² The manufacturer was not sure whether it should be 8mm on one end or both ends and took the liberty of manufacturing tapes with 8mm in length on one end and 22mm on the other.¹³³ When the parts were delivered to the buyer in Beijing, the buyer did not inspect them upon receipt.¹³⁴ When it was later discovered that the tapes could not be used, the buyer refused to pay.¹³⁵ After several failed attempts made by the supervisory government agency to mediate, the manufacturer sued and requested the court to enforce the contract. Lacking a statutory authority such as the ECL, the court did not address the validity of contract directly. The court attributed the responsibilities of the waste of the tapes mainly to the sourcing agent, “a lay person who made the order without fully understanding the business.”¹³⁶ The manufacturer was partially responsible because “they rushed into the project without making sure the specifications and types of the parts, and took the liberty in enlarging the diameters.”¹³⁷ The solution was again reached through court-supervised mediation. As a result, the buyer agreed to return all the tapes and compensated the manufacturer 25% of the contract price.¹³⁸

To Western lawyers, distinct features of Chinese contract law practice are apparent. First, the defendant who should have been bound by the contract concluded by its agent was not legally liable for the breach of contract whilst the defendant still was asked to pay a fraction of the contract price without accepting any parts. As we can see, the courts tended to make SOEs liable for their own negligence in their management’s decision making and contracting. SOEs were not necessarily liable to the other party but to the state, which bore the economic consequence of bad contracting.

The court’s decision in this case was both commended and criticized by the comment. The comment commended the decision in that “the court

¹²⁹ *See id.* at 13.

¹³⁰ *See id.*

¹³¹ The Collection, *supra* note 101, at 13.

¹³² *See id.*

¹³³ *See id.*

¹³⁴ *See id.*

¹³⁵ *See id.*

¹³⁶ *Id.*

¹³⁷ The Collection, *supra* note 101, at 13.

¹³⁸ *See id.*

attributed the liabilities between the parties properly, protected state economic interest and reduced the economic loss for both parties. Such a decision promoted the stability and harmony in the society and the development of socialist modernization.”¹³⁹ The comment further explained that if it were decided under the ECL, the court should have found both parties liable. Article 12 of the ECL requires that the major contract terms be clear and specific. Here, the buyer in its telegraph to the manufacturer did not specify the type and specifications of the parts and sent a merchandiser who was not familiar with the technical details of the parts to make the order.¹⁴⁰ The manufacturer was also liable in performing the contract.¹⁴¹ When in doubt about the diameter of the tapes, they did not ask the buyer for clarification but rather took the liberty to enlarge the diameter. Thus they should be liable for the consequence.¹⁴²

Consistent with this comment, with the enactment of the ECL, the principal became liable for damages caused by the contract entered by an agent exceeding his scope of agency even though contract itself was still deemed null and void.

In a 1984 case where an electrical machinery company concluded a contract with a trading firm to purchase three cars when the signing agent was only asked by the principal, the company, to purchase electrical machinery parts.¹⁴³ The agent sensed the profitability of this car purchase and asked the legal representative, the only agent with appropriate authority to bind the company, to confirm the contract but was rejected.¹⁴⁴ The court annulled the contract citing article 16 of the ECL to determine the form of remedy. Article 16 permitted return of property and restitution damages paid by the party responsible for the nullity when a contract is declared null.¹⁴⁵

b. Ultra Vires

Ultra vires conduct usually coincided with an enterprise or its agents’ attempt to seize market opportunities by engaging in activities outside the scope of their own business. Again, the threat *ultra vires* posed to the traditional government micromanagement of state-owned enterprises made it impossible for the law to give it effect.

¹³⁹ See *id.* at 14.

¹⁴⁰ See *id.*

¹⁴¹ See *id.*

¹⁴² See *id.*

¹⁴³ The Collection, *supra* note 101, at 18.

¹⁴⁴ See *id.*

¹⁴⁵ See *id.*

In a 1985 case, the merchandiser of a company in the sale of agricultural products ordered 500 TV sets from a trading firm at a bargain using pre-prepared contract papers under the proper letterhead and seal of the company.¹⁴⁶ However, the leadership at the agricultural company did not confirm the contract but sent the trading firm a telegraph expressing their intention to rescind it. The trading firm insisted that all the form requirements had been met, and the contract was valid. Therefore, it requested that the court enforce the contract or award them a penalty of 5% of the contract price. The court annulled the contract because the scope of business of the agricultural company should be confined only to the sales of agricultural materials. The sale of TV sets is outside their scope of business, therefore the contract is absolutely null even though it met all the form requirements under the ECL.¹⁴⁷ As a result, the agricultural company neither had to perform the contract entered by their agent nor did they need to pay the penalty or damage.¹⁴⁸ The comment attributed the illegality of the contract to the company's contracting beyond its capacity for civil rights¹⁴⁹ and the agent's unauthorized contracting.¹⁵⁰

Not only would exceeding the scope of one's business make a contract null and void, moving up in the industrial chain in the same industry would produce the same result. In a 1984 case, a bicycle retailer tried to purchase bicycle parts directly from another retailer intending to assemble and eventually sell the bicycles.¹⁵¹ When the retailer could not receive the exact parts it ordered, it sued to enforce the penalty clause and demanded damages along with penalties for breach of contract.¹⁵² The trial court rescinded both its contracts and ordered the return of the payment and the goods that had been received.¹⁵³ The buyer appealed the decision. The appellate court not only reaffirmed the annulment of the contracts but also fined the appellant RMB 5,000 yuan¹⁵⁴ as a punishment for the illegal conduct. The assembling of bicycle parts and the sale of the assembled bicycles by a retailer was illegal because it exceeded the scope of business of the retailer and thus was considered *ultra vires*. According to the appellate court, it was also illegal to purchase the parts at prices above those

¹⁴⁶ See *id.* at 14.

¹⁴⁷ See *id.* at 15.

¹⁴⁸ See *id.*

¹⁴⁹ Capacity for civil rights means the qualification of a subject to enjoy rights and bear obligations under civil law.

¹⁵⁰ See The Collection, *supra* note 101, at 16.

¹⁵¹ See *id.* at 37.

¹⁵² See *id.*

¹⁵³ See *id.* at 38.

¹⁵⁴ See *id.*

set by the state and to plan to resell the assembled bicycles at even higher prices.¹⁵⁵ Such conduct was considered to have disrupted the socialist economic order and harmed the state and consumers' interests.¹⁵⁶

As we have seen, in all these cases, according to the pre-reform theories, any increase in price or deviation from the set scope of business by a single enterprise constituted opportunistic behavior that would harm the implementation of state economic plans and eventually, the interest of the collective system. However, when a growing market partially opened up and private enterprises started to emerge, the previous theories that allowed state to be the sole planner which could control all prices and allocate all resources were no longer compatible with the changes in the economy.

iii. *Binding Force of Contract*

The Communist party leadership realized that the rise of freedom of contract was unstoppable. It accorded more respect to party autonomy and downplayed the role of state planning. As we have seen, in 1993, the same time that the concept of socialist market economy was introduced, the ECL was amended to expand the scope of the persons who were allowed to enter economic contracts to all individual business households and peasants. Also, as we can see from the collection, courts tend to hold that a contract entered into autonomously is binding.

In the pre-reform era, as we have discussed, contracting parties could normally be very insensitive to the terms of contract¹⁵⁷ and would usually tolerate the defective and default of the other party's performance since the state would bear the loss or absorb the profits. However, when a profit retention scheme was introduced, SOEs started paying more attention to the performance of contracts, and, more importantly, the court started to take contracts arising out of mutual negotiations seriously.

In a 1984 case, when the seller of refrigerating equipment failed to tender the exact products ordered – short of 10 sets of modules due to the seller's neglect when placing the orders.¹⁵⁸ The buyer sued for the damages in the amount of RMB 12,600 yuan caused by the defective tender and its disruptive impact on the buyer's production plans.¹⁵⁹ The defendant

¹⁵⁵ *See id.*

¹⁵⁶ The Collection, *supra* note 101, at 38.

¹⁵⁷ *See* POTTER, *supra* note 15, at 22 (known as “signing contract blindly, signing big contracts without investigation.”).

¹⁵⁸ *See* The Collection, *supra* note 101, at 57.

¹⁵⁹ *See id.*

confirmed the facts but disagreed with the scale of the damage.¹⁶⁰ In this case, the buyer was a train and auto repair firm that attempted to acquire refrigerating and ice cream making machines so that it could expand its scope of business to the sale of ice cream.¹⁶¹ It was also said that the firm did so specifically to help employ the adult children of the repair company employees.¹⁶² This conduct was an obviously *ultra vires*. However, the official comment acknowledged that the contract was valid and that the defendant should be liable for its breach.¹⁶³ The comment stated that the damage was excessive and should be reduced. In the end, the case was settled under court-supervised mediation. The seller agreed to deliver the modules they failed to deliver and pay RMB 200 yuan in damages.

In a 1985 case, a buyer returned 200 emergency lights they purchased from the seller and defaulted in payment when they tried but were not able to sell the lights over the market.¹⁶⁴ In the pre-reform era, such an attempt to back out a contract would have been excused. However, in this case, the court ruled the contract was concluded through mutual consultation between the parties for their mutual benefit. The contract did not violate either mandatory law or state policies, and therefore was valid.¹⁶⁵ According to the court, overstocking was not a valid ground to excuse contractual performance.¹⁶⁶ The court, to protect the interest of the contracting parties, cited article 38 of the ECL finding liability for the breach of contract, and ordered the buyer to make the payment it had failed to pay, to pick up the lights it returned to the seller and to pay the economic penalty incurred.¹⁶⁷ This case marked the court's respect for party autonomy, and the independent legal personality of the contracting party who bears contractual liability.

In another 1985 case, a county-owned retailer, refused to recognize and pay for a sales contract for the purchase of plywood flooring tiles entered during the administration of the previous legal representative, then general manager.¹⁶⁸ The defendant argued that because the contract was entered into during the administration of the previous general manager and Communist party secretary, the current manager had no authority to pay for

¹⁶⁰ *See id.*

¹⁶¹ *See id.*

¹⁶² *See id.*

¹⁶³ *See id.* at 58.

¹⁶⁴ The Collection, *supra* note 101, at 54.

¹⁶⁵ *See id.* at 56.

¹⁶⁶ *See id.*

¹⁶⁷ *See id.*

¹⁶⁸ *See id.* at 97.

the contract and no knowledge of it.¹⁶⁹ In addition, the defendant took advantage of the absence of the doctrine of apparent authority and argued that the merchandiser concluded the contract with the plaintiff-supplier without the consent of the then Communist party leadership at the retail firm.¹⁷⁰ The court acknowledged the validity of the contract because it was formed on the basis of “the principles of equal status and mutual benefit of the parties, mutual consultation, and compensation for equal values” and “consent was reached after the inspection of the plywood tiles.”¹⁷¹

The court ordered the defendant to render the payment under the contract by the end of the year. Nevertheless, it rejected the claim for an economic penalty for a non-legal reason- to accommodate the financial difficulties the defendant was undergoing.¹⁷²

The official comments reasoned that the enterprise was bound although the legal representative or authorized agent who entered into the contract had left office.¹⁷³ That person had entered into the contract on behalf of the enterprise, and the performance of the contractual obligations should not be affected by the change of personnel.¹⁷⁴

Such a development was in severe contrast with a 1980 case decided just before the enactment of the ECL. In this case, the court acknowledged that the obligation to manufacture qualified products was owed to the state rather than the other contracting party.¹⁷⁵ The manufacturer sued to enforce payment although the glass tiles they manufactured were substandard.¹⁷⁶ The court rejected their claim and said that the plaintiff failed to fulfill its obligation to the state by manufacturing sub-standard products.¹⁷⁷ The manufacturer was condemned for doing so and withdrew its suit upon the court’s recommendation.¹⁷⁸

iv. Loss Splitting

Even though several years into the economic reform there was a notable increase in contractual autonomy and in the incentive to make profits, the state remained the sole stakeholder in allocating losses. The state

¹⁶⁹ *See id.* at 98.

¹⁷⁰ The Collection, *supra* note 101, at 98.

¹⁷¹ *See id.*

¹⁷² *See id.*

¹⁷³ *See id.*

¹⁷⁴ *See id.* at 99.

¹⁷⁵ *See id.* at 58.

¹⁷⁶ The Collection, *supra* note 101, at 58.

¹⁷⁷ *See id.*

¹⁷⁸ *See id.*

was the sole victim of abrupt contracting and profiteering at the expense of the state policies and economic planning. This was especially true when hard budget constraints were not imposed so that SOEs could still compete with private enterprises while pursuing goals other than profit maximization. As a result, in giving remedies, courts tended to split the losses between the contracting parties regardless of who was liable so that the financial difficulties of one contracting party could be accommodated through a reduction of damages. As a result, SOEs that would have been closed down could stay in business, and the losses the system suffered could be spread among a few SOEs, or even among contracting parties that did not have government affiliation, such as individual business households (single family-owned proprietorships).

In a 1984 case, the defendant, an individual business household, refused to pay for the substandard silk weaving materials it had they ordered from the plaintiff, a cotton factory.¹⁷⁹ The official comment acknowledged the fact that the quality of the products was substandard and that liability should be borne by the plaintiff.¹⁸⁰ However, through court-supervised mediation, the defendant agreed to pay for the material at a reduced price.¹⁸¹ The court's "careful and thorough work" on the case and the appropriate solution it provided were commended by the official comment.¹⁸²

In a very similar case between two SOEs where the defendant refused to pay for the cotton cloth they ordered from the plaintiff, the defendant's only argument was that it did not have the financial means to pay. Consequently, it only paid RMB 50,000 yuan out of the contract price at RMB 1,398,268.65 yuan one year after the partial payment of RMB 1,211,353.78 yuan was due.¹⁸³

The official comment explained that the contract was concluded through mutual negotiations without any violation of state law or policies and therefore it was a valid contract.¹⁸⁴ The defendant's default in payment constituted breach of contract. However, to accommodate the defendant's financial difficulties, under the court's supervision, both parties reached agreement that the defendant would pay for the rest of the RMB 1,211,353.78 yuan that was due at the time, but not the contract price of 1,398,268.65 yuan, and the plaintiff agreed to excuse the defendant from

¹⁷⁹ *See id.* at 78.

¹⁸⁰ *See id.* at 79-80.

¹⁸¹ *See id.*

¹⁸² The Collection, *supra* note 101, at 79-80.

¹⁸³ *See id.* at 80.

¹⁸⁴ *See id.* at 81.

performing the rest of the contract.¹⁸⁵ According to the collection, default in payment resulting from financial difficulties could be resolved by returning the products to the supplier.¹⁸⁶ The official comment considered it a sound solution to have the defaulted buyer return the products to the supplier. This way the loss suffered by the collective system was minimized.

In dealing with contract disputes, rather than engaging in legal analysis, the comment encouraged the courts to engage in ideological counseling¹⁸⁷ between the parties so that the supplier could understand the policy importance to accommodate buyer's financial difficulties while the buyer would appreciate the disruptive effect their default in payment had caused to the production. With mutual understanding, both parties should actively search for solutions that were most beneficial to the system under the court's supervision. Such solutions could be the return of the products, using other merchandises to substitute cash as a form of payment, or payment by installments, or promise to pay when the financial situation improves under the sponsorship of superior government authority.¹⁸⁸

A perfect demonstration of the courts' active role and flexibility in solving contracting disputes in order to serve the system rather than to respecting contracting parties' rights is a pre-ECL case decided in 1979. An SOE entered into a contract with another SOE at a materials trade fair to sell 54 tons of steel to a state-owned steel window manufacturer.¹⁸⁹ However, it turned out that the same 54 tons had been sold to a light industrial bureau for its affiliate factory even before the fair took place.¹⁹⁰ No written contract was signed, and no payment had been made by the bureau at the time the contract was entered into at the trade fair.¹⁹¹ Both buyers insisted that they be entitled to the steel. The bureau argued that their contract was entered first.¹⁹² Both the court and the official comment recognized only the second contract entered at the trade fair,¹⁹³ probably because only the second contract satisfied the written requirement. However, the court eventually ordered 30 tons of the steel be sold to the window factory and assigned to the bureau the other 24 tons.¹⁹⁴ The

¹⁸⁵ *See id.* at 80.

¹⁸⁶ *See id.*

¹⁸⁷ In such counseling, courts would educate parties what Communist ideology expects them to do. The aim would be for the parties to prioritize the interest of the collective system before their individual interest.

¹⁸⁸ The Collection, *supra* note 101, at 83, 84.

¹⁸⁹ *See id.* at 26.

¹⁹⁰ *See id.*

¹⁹¹ *See id.* at 91.

¹⁹² *See id.* at 27.

¹⁹³ *See id.*

¹⁹⁴ The Collection, *supra* note 101, at 27.

flexibility, creativity and discretion the court exercised in the situation was commended by the commentary. Such a solution did not harm the parties' interest while at the same time "enhanced the social economic efficiency."¹⁹⁵

V. CORPORATIZATION AND THE THEORETICAL INCOHERENCE

A. *Corporatization*

In an economy where private ownership and competitive markets are the norm, it is easier to justify the freedom of contract since a reasonable person should be allowed to dispose of his property and to contract to determine his own fate and bear the negative consequences accordingly. On the other hand, in an economy where a market is absent, state ownership of means of production is exclusive, and the allocation of resources is centralized, as in pre-reform China, every SOE exercises their operational management rights by entering into contracts on behalf of the state. It was consistent with the socialist theories to deny freedom of contract in order to prevent opportunistic behavior by these SOE managers, the agents of the state. The socialist theories were by and large coherent. However, in the first decade of Chinese economic reform, both theories became inapplicable to China. There was a rapidly growing private economy outside the dominant state sector, and a dual track price system that allowed market prices to exist in parallel of the fixed prices in the planned economy. This new paradigm created the theoretical nuance that would fit in contract theories in neither traditional socialist economy nor the Western capitalist model.

At the beginning, profit retention and increased autonomy brought efficiency and proper incentives back to State sector. However, due to the continued absence of a competitive market, and the information asymmetry that comes with it, the reform failed to resolve the problem of managerial opportunism that the pre-reform system aimed to prevent. Ten years into the economic reform, the economic efficiency and profitability of SOEs stalled. Low profitability became common among SOEs. For example, the after tax profit of SOEs decreased from 6.6% in 1987 to 1.8% in 1994.¹⁹⁶ Increased bank loans were made available upon request to support the SOEs at the below market rates. However, the number of non-performing loans continued to accumulate when the efficiency of the SOEs stalled. Corporatization was introduced to accelerate the reform progress.

¹⁹⁵ *See id.*

¹⁹⁶ *See* LIN, *supra* note 16, at 66.

As part of the small-scale privatization effort, the rise of stock exchanges and equity exchanges allowed private investors to become the minority shareholders of large scale SOEs. In addition, restructuring, as a popular device, was introduced to privatize inefficient small and medium enterprises. Both devices serve to further privatize Chinese economy. Nevertheless, in contrast to the former Soviet and East European models, no program allowed the wholesale divestment of state enterprises program to be undertaken.¹⁹⁷ As a result, no massive asset stripping took place that on the scale of that in the Soviet Union.

To facilitate the transformation of a planned economy to a market economy, the ECL was amended in 1993. The Company Law of China was also adopted in the same year.¹⁹⁸ The amended ECL added two types of family-owned sole proprietorships: peasant households and private-owned business households, as parties who are allowed to enter into economic contracts.¹⁹⁹ Also, in the amended article 7 of the ECL, violation of Communist Party economic policy was no longer a cause for nullifying a contract,²⁰⁰ which signified the end of the planned economy. The then-newly enacted Company Law did not limit legal persons to SOEs and therefore opened the floodgate to allow privately-owned enterprises to register as corporations and assume the status of legal persons.²⁰¹ In 1999, the Contract Law, a product of legal transplantation resembling the United Nations Convention on Contracts for International Sales of Goods (CISG), adopted freedom of contract as a basic principle.²⁰² Rules that one would expect in a major Western civil code are now in place to protect contractual autonomy and transactional safety. Parties now have the autonomy to decide whether to contract, with whom to contract, and on what terms. The doctrines of apparent authority, *ultra vires* activities and voidability were introduced. Upon breach of contract, the aggrieved party can now choose the form of remedy between monetary damages and specific performance. Plans and policies, which were once dominant, no longer play an official role in contracting and the Contract Law statute.

Nevertheless, it is not the case that the Statute is and shall be equally

¹⁹⁷ See Lan Cao, *The Cat That Catches Mice: China's Challenge To The Dominant Privatization Model*, 21 BROOK. J. INT'L L., 97, 106 (1995).

¹⁹⁸ Before the promulgation of Company Law, there were two separate statutes dealing with state-owned enterprises and privately-owned enterprises separately.

¹⁹⁹ See Economic Contract Law, *supra* note 118, art. 2.

²⁰⁰ However, this does not mean SOEs have stopped following state economic policies closely.

²⁰¹ 中华人民共和国公司法 [Company Law of the People's Republic of China], arts. 2 & 3.

²⁰² See 中华人民共和国合同法 [Contract Law of People's Republic of China], art. 4.

applied to all parties regardless of their ownership status. In the West, market competition and fiduciary duty hold managers accountable for their imprudent managerial performance. This is still hardly the case for Chinese SOEs. Even though reforms have been carried out to invigorate SOEs, the market is still not sufficiently competitive and fiduciary duty principles are ineffective in imposing the managerial accountability. The fiduciary principle, as in the West, functions to protect the principal's reliance interest. In China, without such a market, prices can be suppressed for policy reasons. Since SOEs are also pursuing goals other than profit maximization, the usual market indicator, profitability, does not provide sufficient information to the state. As a result, non-profitable transactions could be carried out for policy considerations. On the one hand, a low price itself is not sufficient to prove a SOE manager's breach of fiduciary duty. On the other hand, it is impractical and unrealistically expensive for the state, as the sole shareholder or controlling shareholder, to monitor the contracting of individual enterprises. Additionally, the state's low sensitivity to profits compared to private investors makes the state a passive principal who is not actively pursuing its own financial interest.

Behaviors of SOE managers, on the other hand, could not be controlled by an effective incentive structure that provides incentive compatibility. I described the problem in an earlier article as follows:

Managers in state-owned enterprises are government employees more than businessmen and lack personal incentives and financial stakes in running the business. Managers receive salaries that are comparable to government employees with similar bureaucratic ranks, and directors and officers can be laterally transferred to other government agencies in the event the SOE goes bankrupt. Since these quasi state-officials are not nearly as motivated as private entrepreneurs, since they are not accountable to shareholders for their grossly negligent business decisions, when it comes to decide whether a contract should be nullified.²⁰³

In a true market economy, contractual autonomy should extend to SOEs as well. The state-owned enterprises are no longer established for the sole purpose of implementing state policies. Most of them are for-profit and operate under the leadership of their own management rather than

²⁰³ Hao Jiang, *Enlarged State Power to Declare Nullity: the Hidden State Interest in the Chinese Contract Law*, 7 J. CIV. L. STUD. 147, 188 (2014).

government authorities. Therefore, SOEs are market participants whose interests should receive only as much protection and supervision as private parties. However, the state retains a supervisory power over the management through the authority of the State-owned Asset Supervision and Administration Commission²⁰⁴ and various ministries and financial regulatory bodies. At the same time, policy induced burdens, soft budget constraints, and artificial entry barriers still exist. On one hand, they burden SOEs; on the other, they help them survive market competition.

In order to better monitor SOE performance, many statutes, administrative regulations and departmental rules have been enacted since the late 1980s designed to curb managerial opportunism in SOE's and to realign the disparity between their goals and those of the state. In order to curb the managerial opportunism and prevent asset stripping, several regulations have been put in place to require asset appraisal, and, in major transactions, state approval in contracts disposing of state assets.²⁰⁵ The asset appraisal procedure might serve as an *ex ante* deterrent to asset-stripping. However, for the *ex ante* deterrent to function, when a flaw in the asset appraisal process is later detected, an *ex post* standard must be established to determine whether asset stripping took place. Such a standard should be the substantive fairness of the transaction. When the contract price was not substantively fair, courts, at the request of the aggrieved SOE, should be empowered to annul the contract when no legitimate policy or business reasons for the low price can be established. However, Chinese courts have claimed that they are not in a position to review the alleged unlawfulness in the asset appraisal procedure even when evidence shows the procedure was violated.²⁰⁶ Moreover, according to the court, violations in such procedures alone do not amount to asset stripping.²⁰⁷

²⁰⁴ SASAC was created in 2003 to exercise state's shareholder rights within the SOEs. SASAC has the authority to appoint the management personnel, supervise major management decision-making and the use of state-owned assets. See 国务院关于机构设置的通知 (国发(2008) 11号)[State Council's Notice on Agency Creation] (Guo Fa (2008) No.11).

²⁰⁵ See, e.g., 中华人民共和国企业国有资产法 [State-owned Assets Law of the People's Republic of China] (adopted by the Standing Comm. Nat'l People's Cong., Oct. 28, 2008, effective May 1, 2009); 企业国有资产监督管理暂行条例 [Provisional Methods on Supervision of State Assets Appraisal] (promulgated by the State-Owned Assets Supervision and Administration Commission, May 27, 2003, effective 2005); 国有股东转让所持上市公司股份管理暂行办法 [The Provisional Methods on Supervision of Holder of State Shares' Transfer of State Shares] (promulgated by the State-Owned Assets Supervision and Administration Commission, effective July 1, 2007), art. 7; 国有资产评估管理办法 [Rules on the Appraisal and Management of State Assets] (promulgated by the State Council of China, Nov. 16, 1991), art. 3.

²⁰⁶ See *infra* note 216 白商初字第231号 [(2013) Bai Shang Chu Zi No.231].

²⁰⁷ See *id.*

On the other hand, the state has rewarded SOE managers by giving out bonuses for making profits and punished them by cutting salaries for operating the SOEs at a loss. These efforts are designed to preserve state assets, encourage a market economy, and also increase managerial efficiency. The two goals seem to contradict each other. The first limits the freedom of contract beyond what one would expect from the statutory and doctrinal interpretations, such as freedom to decide contract terms or to set prices, and the second increases managerial and contractual autonomy. According to Yifu Lin, such reform efforts could not be successful and complete because of the lack of a fair and competitive market.²⁰⁸ Despite reform, SOEs continue to carry out non-profit driven goals to serve the state's policy and strategic interests. In order for SOEs to survive, the state must provide direct and indirect subsidies and soft budget constraints. Accordingly, profit level in a non-competitive market does not reflect the managerial performance. Consequently, as Joseph Stiglitz pointed out, without functioning market competition, a rational incentive structure cannot be formed.²⁰⁹ The absence of competitive market further warrants the deprivation of full enterprise autonomy to avoid asset stripping. Due to the economic reform, the doctrinal coherence of socialist contract theory was lost. As a result, courts are often at loss and decisions may vary from respecting the external formalism of the transaction to honor freedom of contract to substantive review of the fairness of the transaction in order to prevent asset stripping.

B. The Theoretical Incoherence

Though massive privatization of SOEs never took place in China as in the Central and Eastern Europe, privatization of small and medium SOEs and market capitalization of the non-controlling interest of the major SOEs allow private sector actors to acquire state assets through contractual transactions. Through these transactions, freedom of contract had been abused by SOE managers in pursuing personal agendas that are often incompatible with the interest of the principal, the state. Examples are selling state-assets too cheaply or choosing to contract with parties who are related to them or who most heavily bribed them. However, even when the managers are convicted for corruption or abuse of power by a government or SOE employee, the contract itself is still valid. The courts do not have a solid theoretical ground to annul such contracts on their own initiative or upon the request of the aggrieved party unless fraud or duress can be

²⁰⁸ See LIN, *supra* note 16, 125-153.

²⁰⁹ See JOSEPH E. STIGLITZ, *WHITHER SOCIALISM?* 111 (MIT Press, 1994).

proved.²¹⁰ Will theories deny there is a just price for things, as the value is subjective and “depends on the mere judgment of men.”²¹¹ Therefore, in principle, both common law and civil law rejected relief for an unjust price.²¹² However, the premise for such a view is that a reasonable person should determine his own fate by contracting and therefore bear the negative consequence of a bad bargain. However, this argument does not apply to Chinese SOE managers, who would contract on behalf of the state while having the state bear the negative consequence.

i. Abuse of Freedom of Contract

The principle of freedom of contract discourages courts from examining whether the price of a contract is just. However, given the absence of a competitive market and state’s inability to monitor every single contractual transaction carried out by SOE managers, it is unavoidable that freedom of contract will be abused in the sale of state assets, privatization of smaller SOEs, and many bidding procedures. SOE managers have the incentive to deal with their relatives, and with the people who bribed them most heavily or transfer the state assets into their own hands at lower than the market value. Though all such conducts are punishable by criminal law, contracts entered by these managers are not absolutely null. They should not be in principle. Even though SOE managers committed criminal conduct in contracting, the SOE might still have business or policy reasons to keep the contract. However, according to both the decisions of the Supreme Court²¹³ and the State Assets Law,²¹⁴ transactions that concern either the sales of small sized SOEs²¹⁵ or state assets, shall automatically be declared null if there was a malicious conspiracy that harms the state interest. Nevertheless courts, out of respect for freedom of contract, do not examine whether the contracts that result from corruption, bribery and

²¹⁰ Article 52, section 1 of the Contract Law provides a leeway for SOEs to back out a contract by arguing that state interest, which is represented by the SOE’s financial interest was harmed by fraud and duress, and the contracts, though for various reasons were not annulled as an annulable contract, could now be declared absolutely null. *See generally* Hao Jiang, *Enlarged State Power to Declare Nullity: the Hidden State Interest in the Chinese Contract Law*, 7 J. CIV. L. STUD. 147 (2014).

²¹¹ *See* GORDLEY, *supra* note 25, at 1592.

²¹² *See id.*

²¹³ 最高人民法院关于审理与企业改制相关的民事纠纷若干问题的规定 [Supreme Court Rules on various issues regarding civil disputes in restructuring of state-owned enterprises].

²¹⁴ *See* 中华人民共和国企业国有资产法 [Law on State-owned Assets in Enterprises of the People’s Republic of China] (promulgated by the Standing Comm. Nat’l People’s Cong., Oct. 28, 2008, effective May 1, 2009), art. 72.

²¹⁵ In China, privatization of SOEs only extends to small and medium SOEs.

conspiracy were tantamount to stripping state assets. The passivity of judicial practice, in a sense, encourages the stripping of state assets.

In a 2013 case that concerns a dispute over the equity interest within a privatized former SOE, the court abstained from assessing the fairness of the price in a stock purchase agreement.²¹⁶ The plaintiff claimed that the methods used in the asset appraisal was inconsistent with the methods required by the *Provisional Methods on Supervision of State Assets Appraisal*²¹⁷ The court ruled that such a violation did not affect the validity of the stock purchase agreement.²¹⁸ The court reasoned that as the *Provisional Methods* is merely an administrative regulation, its regulations on the methods for asset appraisal are not mandatory requirements.²¹⁹ Therefore, the violation did not affect the validity of the contract.²²⁰ As to the potential harm to public interest, the court opined that its role is limited to examining the external form of the commercial transaction rather than its substance in order to protect the security of the transaction.²²¹ In addition, the court argued that since the form of the transaction complied with the legal requirements, the problems regarding the asset appraisal did not necessarily amount to a harm to the public interest.²²²

In a 2014 case, the County Administration of Forestry sued to annul a contract in which a house owned by its subsidiary SOE was sold to two individuals.²²³ The sale was made through a procedurally sound public bidding process. Nevertheless, the SOE general manager was later convicted of receiving bribes from the individuals that won the bidding.²²⁴ The court upheld the validity of the sales contract.²²⁵ The contract was the product of the genuine meeting of minds of the both parties, the SOE and the two individuals.²²⁶ The court reasoned that neither the corrupt manager nor the two individuals were a party to the contract.²²⁷ Moreover, the SOE

²¹⁶ See 张芸. 江苏省演艺集团 [Zhangyun v. Jiangsu Group of Performing Arts] (2013) 白商初字第231号 [(2013) Bai Shang Chu Zi No. 231]. (Qinhuai District Court of Nanjing 2013).

²¹⁷ See *id.*

²¹⁸ See *id.*

²¹⁹ See *id.*

²²⁰ See *id.*

²²¹ See *id.*

²²² See *id.*

²²³ 黟县林业局 v. 方山 [Yi County Forestry Bureau v. Fang Shan] 宣中民四终字第00105号 [(2014) Xuan Zhong Min Si Zhong Zi No. 00105] (Yuan Cheng Municipal Intermediary Court 2014).

²²⁴ See *id.*

²²⁵ See *id.*

²²⁶ See *id.*

²²⁷ See *id.* According to article 52, section 2 of the Contract Law, “malicious conspiracy committed to harm the state interest” will render a contract null and void.

manager's receipt of bribes is not sufficient to prove that there was a malicious conspiracy that harmed the state interest and the state assets were sold at a low price.²²⁸ The court again abstained from evaluating the fairness of the transaction when the evidence should have given rise to the presumption of assets stripping.

This pattern is consistent. In a 2013 Supreme Court case, the Supreme Court upheld the trial and appellate courts decisions to affirm the validity of the asset transfer agreement that allowed major state assets owned jointly by a wholly state-owned enterprise and a state holding enterprise to transfer the land use rights²²⁹ of certain housing to a Japanese invested company to offset debts in the amount of RMB three million yuan.²³⁰ The plaintiff sued to annul the contract because the asset transfer neither went through the required asset appraisal, or the public bidding process, nor did the transaction obtain the SASAC's approval.²³¹ Still, the Supreme Court agreed with the lower courts that failure to comply with these procedures was not sufficient to prove that there was harm to the state interest by a malicious conspiracy between the SOE and the foreign invested enterprise to transfer state assets at a lower price.²³²

Consequently, the court's passivity in intervening in these cases encouraged the abuse of freedom of contract and aided the SOE managers stripping state assets for their own benefits. In each of these cases, I would argue that, a conviction of bribery and corruption, or flaws in asset appraisal or the omission of such a procedure should be a reason to deny the SOE managers the same contractual autonomy in disposing of state assets as freedom of contract would allow in the West and allow courts to avoid contracts that were concluded for the sole purpose of asset stripping.

If Chinese law protects only external formalism in transactions where SOE decision makers do not have to bear the negative consequences of the contracting, freedom of contract will lose its value. If a party does not have to bear these consequences, it will not always look out for the best interest of the enterprise. Insensitivity and incompatible incentives arise. When the state has to bear the negative consequences of the SOE's disposing of state

²²⁸ *See id.*

²²⁹ There is no private ownership of land in China so land use right is the most ownership right a private party can have over the land.

²³⁰ *See* 陈发树v.云南红塔 [Chen Fashu v. Yunnan Hongta Group] (2012) 云高二民初字第1号 [(2012) Yun Gao Er Min Chu No.1]. *See also* 陈发树 v. 云南红塔集团有限公司 [Chen Fashu vs. Yunnan Hongta Group Co., Ltd.], (Sup. People's Ct. 2013)(China)(2013)民申字第2119号 [(2013)Min Shen Zi No.2119].

²³¹ *See id.*

²³² *See id.*

assets, the price of a contract and fairness matter. The will expressed by a contracting party to dispose of state assets for an unfair price should be invalid if the sole motive for the transaction was to strip state assets. It is one thing to allow private investors to decide whether the prices of their contracts appear advantageous to them. It is another to allow SOE managers to have the same level of freedom. Applying freedom of contract to SOEs to its full extent encourages the stripping of state assets. Denying it fully will make commercial dealings impossible in the Chinese society. In my view, freedom of contract should be the default norm, yet the just described call for an enhanced judicial review of the substantive fairness of the transaction should be adopted when the circumstances warrant it.

ii. *Interference with Freedom of Contract*

Conversely, examples can be found where the state interfered with contractual autonomy by allowing an SOE to renege a bad bargain. This is done through placing a suspensive condition in the contract that depends solely on the state's will or whim. If the state were a party to the contract, such a condition would be a potestative condition that would have rendered the condition null. However, technically, the state is not a party to the contract though it has a controlling equity interest in the contracting party and is financially affected by its own administrative decision that is under its unbridled discretion.

As we will see in the *Chen Fashu* case, when a private investor won a public bidding and was qualified to purchase state shares, it is not clear who is the appropriate state authority that gives the final approval when state assets are traded. This approval or disapproval may be given years after a contract is concluded. In the meanwhile, the validity of the contract continues to be uncertain. Moreover, the state does not have to give any reasons for disapproving a transaction. The SOEs will only go through the transaction when honoring the contract will not result in loss of state assets. This practice shields an SOE from the risk of price fluctuation and gives an SOE a free way out of a bad bargain.

In *Chen Fashu v. Yunnan Hongta Group*,²³³ Mr. Chen, a private investor entered a stock purchase agreement that allowed him to buy 12.32% of the tradable state-owned shares of Yunan Baiyao Corp. owned by a major SOE, Yunnan Hongta Group, at a price of RMB 2.2 billion

²³³ See 陈发树v.云南红塔 [Chen Fashu v. Yunnan Hongta Group] (2012) 云高二民初字第一号 [(2012) Yun Gao Er Min Chu No.1].

yuan.²³⁴ The contract was concluded in September 2009 and conditioned upon the approval of the superior government authority.²³⁵ However, the transaction was never submitted either to the direct supervisory ministry of the SOE, the ministry of finance, or to SASAC for approval as the contract or the state regulations required.²³⁶ Two years after the conclusion of contract and the tender of payment, the stocks had not been transferred to Chen.²³⁷ Chen finally sued to enforce the contract in December 2011 when the value of the stock purchased had more than tripled, and reached RMB 6.8 billion yuan.²³⁸ While the stock price was increasing, Chen repeatedly urged the defendant to perform the contract but was only told that the transaction was pending approval.²³⁹ Less than a month after the suit was filed, a separate company that happened to be Hongta's bureaucratic superior, China Tobacco Corp., issued a decision to disapprove the transaction.²⁴⁰ The trial court upheld the validity of the contract itself but refused to give Chen any remedies permitted under the contract, without giving reasons. When the case was appealed to the Supreme Court, the Court held that the contract did not take effect because the condition for state approval was not met.²⁴¹ Since there was no contract, the court granted restitution damages and ordered Yunnan Hongta to return the RMB 2.2 billion yuan with interests to Chen,²⁴² which was significantly lower than the current value of the stock. At the end of the day, the court allowed an SOE to back out of a fully negotiated contract between two sophisticated and resourceful parties with the sole purpose of preserving the value of state assets. The reality is that the current contract theory did not take a solid stance that will keep the court from invading freedom of contract and lending a hand to an SOE when the state assumes the role both as the referee and a player.

In this case, the appropriate supervisory authority was not SASAC or other government agencies but a centrally-owned SOE, China Tobacco Company that exercised the quasi-administrative function in disapproving the sales of state shares two years after the contract was concluded, the RMB 2.2 billion yuan purchase fund had been received when the stock prices had already tripled. The mechanism that conditioned the validity of

²³⁴ *Id.*

²³⁵ *Id.*

²³⁶ *Id.*

²³⁷ *Id.*

²³⁸ *Id.*

²³⁹ *Id.*

²⁴⁰ *Id.*

²⁴¹ 陈发树 v. 云南红塔集团有限公司 [Chen Fashu vs. Yunnan Hongta Group Co., Ltd.], (Sup. People's Ct. 2013)(China) 民二终字第42号 [Min Er Zhong Zi No.42].

²⁴² *See id.*

the contract on appropriate government approval in fact shielded an SOE from bearing the negative consequences of contracting while placing all the risks on a private party. Both the provincial high court and the Supreme Court dismissed the claims for either specific performance, or alternatively, the expectation damage. In fact, all that Chen, the private investor, asked for in this litigation was to submit the deal to the superior government agency of the China Tobacco Company, the Ministry of Finance, for approval. Therefore, even if Chen ever succeeds in the litigation, it only meant Hongta, the SOE, would be obligated to perform its contractual obligation by submitting the deal for approval.²⁴³ Even then the Ministry of Finance has the unbridled discretion to disapprove the deal, and the law would not afford the private investors any remedy in that case. Nevertheless, both courts denied such a request.²⁴⁴

In my view, for freedom of contract to achieve theoretical coherence in China, it is important to require the expression of wills to be legitimate and to allow courts to evaluate the substantive fairness of a transaction. Such enhanced judicial scrutiny shall only be exercised upon the request of an SOE when its manager has been convicted of corruption and abuse of power, and when an SOE attempts to withdraw from a bad bargain that was fair upon its conclusion. In these circumstances, the will expressed of the parties is expressed for the sole purpose of stripping state assets or giving an SOE a free way out, and is not legitimate. In evaluating the substantive fairness of a transaction, courts should enforce a contract when an SOE refuses to perform to avoid a bad bargain in the name of protecting state assets or for the want of state approval. On the contrary, in finding that a transaction was substantively unfair and that the contract entered by an SOE was for the sole purpose of stripping state assets, the courts have rescinded the contract at the request of the aggrieved SOE. Nevertheless, when the disparity in price can be explained by business or policy considerations, courts should give deference to the contract terms and hold the contract valid.

²⁴³ See 云南白药股权官司调解未成：陈发树拒绝红塔只付利息 [Hongta Settlement fell through: Chen Fashu rejected Hongta's offer to return the fund and pay the interests], SINA (Dec. 6, 2013, 6:59 AM), <http://finance.sina.com.cn/chanjing/gsnews/20131206/065917548849.shtml>.

²⁴⁴ See *Chen Fashu v. Yunnan Hongta Group*, Yun Gao Er Min Chu No.1 (云高二民初字第1号) (Yunnan Provincial Higher People's Ct. 2012); see also 民二终字第42号 [Min Er Zhong Zi No.42] (Sup. People's Ct. 2013).

iii. When Fairness is Irrelevant

In general, outside the very specific circumstances discussed where freedom of contract might be abused or violated due to state ownership, freedom of contract should prevail. Fairness of the contract matters less when contracting parties are private parties who can determine their own fates and shoulder the negative consequences of contracting or when there is a policy reason for the disposing of state assets at a low price. Such reasons include taking care of SOE workers who have been laid off and administrative redistribution of state assets from one party to the other. Applying Gordley's theory, such transactions are not pure exchanges but really to exercise the liberality to confer benefits to the other party.²⁴⁵

In Chinese law, there are doctrines available to rectify one-sided contracts as in the Western law such as fraud,²⁴⁶ duress,²⁴⁷ mistake²⁴⁸, and procedural and substantive unconscionability.²⁴⁹

As we can see from the cases, when there is no significant state interest at stake and a policy reason to support a lower than fair market price, courts rule in favor of freedom of contract regardless of the actual fairness of contract.

In a 2012 appellate case regarding a dispute over the rent in a land contract, the appellate court affirmed the trial court's decision to uphold the lower rent specified in the contract and denied the SOE's claims that the

²⁴⁵ See Gordley, *Equality in Exchange*, *supra* note 1, at 1616, 1624.

²⁴⁶ Article 54 of Chinese Contract Law provides grounds for the voidable contracts. It provides:

A party shall have the right to request the people's court or an arbitration institution to modify or revoke the following contracts:

(1) those concluded as a result of significant misconception;
(2) those that are obviously unfair at the time when concluding the contract. Zhonghua Renmin Gongheguo Hetong Fa 中华人民共和国合同法 [Contract Law of the People's Republic of China art. 54].

²⁴⁷ *See id.*

²⁴⁸ *See id.*

²⁴⁹ Procedural unconscionability corresponds to exploitation of the other party's weakness and is defined as "[o]ne party compelling the other side to express will in violation of his true will in time of the other's difficulty in order to seek illicit benefits and seriously impair the other side's interests." SUP. PEOPLE'S CT., OPINIONS OF THE SUPREME PEOPLE'S COURT ON SEVERAL ISSUES CONCERNING THE IMPLEMENTATION OF THE GENERAL PRINCIPLES OF THE CIVIL LAW OF THE PEOPLE'S REPUBLIC OF CHINA art. 70 (1988).

Substantive unconscionability, known as obvious unfairness is defined as "[o]ne party's violation of principle of fairness and compensation of equal value caused the disproportionality between an opposing party's rights and obligations by making use of his own advantages or the lack of experience of opposing party." *Id.* art. 72. Chinese law requires procedural unconscionability in addition to unfair terms to satisfy obvious unfairness.

contract was unenforceable because of obvious unfairness and changed circumstances.²⁵⁰ In this case, a wholly state-owned farm (“the farm”) signed a land contract leasing 4.82-mu of farmland to a then retiring employee, Teng Meicai (“Teng”).²⁵¹ The lease was for a 15-year term, from 2003 to 2018, at the annual rent of RMB 200 yuan/mu.²⁵² The rent was considered at the time of the lawsuit to be below market.²⁵³ The contract provided managing the leased farmland as Teng’s new employment. Since his retirement, Teng was categorized as self-employed and had to pay his own social welfare. Teng had since subleased the farmland to others using the rent as the main source of income, which was allowed under the contract.²⁵⁴ The farm had received the rent of RMB 200 yuan/mu until 2011.²⁵⁵ Then the farm sought to increase the annual rent to RMB 1,500 yuan/mu.²⁵⁶ When Teng refused to pay the higher rent, the farm sued in 2011 to either terminate the contract or increase the rent to the market level.²⁵⁷

The court requested a third party agency to appraise the fair rent of the farmland. It appraised the annual rent at RMB 1,447 yuan/mu for the period of 2011 to 2018.²⁵⁸ Nevertheless, concurring with the trial court, the appellate court upheld the original terms of the contract and ordered the state-owned farm to perform them. The court invoked the principle of freedom of contract, stating that “contract law protects the parties’ freedom to contract voluntarily and whatever terms are agreed by both parties that are not against the law are legally binding.”²⁵⁹ The court further reasoned that modification of a contract needs mutual consent that is lacking in this case.²⁶⁰ The court rejected the farm’s argument concerning the obvious unfairness of the low price for two compelling reasons. One is to interpret the purpose of the contract as a subsidy and the other is the significant disparity in financial capacities between the two parties. The rent constituted the distribution of welfare benefits, as seen by the fact that the farm cut Teng off the welfare benefits by allowing him to live off the leased

²⁵⁰ See 南宁市路东养猪场 v. 滕美才 [Nanning City Road East Farms v. Teng Meicai], (Nanning Municipal Interim. People’s Ct. 2012 (China)). (2012) 南市民二二终字第397号 [(2012) Nan Shi Min Er Er Zong Zi No. 397].

²⁵¹ See *id.*

²⁵² See *id.*

²⁵³ See *id.*

²⁵⁴ See *id.*

²⁵⁵ See *id.*

²⁵⁶ See *id.*

²⁵⁷ See *id.*

²⁵⁸ See *id.*

²⁵⁹ *Id.*

²⁶⁰ See *id.*

farmland and to sublease it.²⁶¹ Therefore, the RMB 200 yuan/mu rent was not subject to the market rent.²⁶² Also, having defined the purpose of the contract as a sort of subsidy, neither changed circumstances, obvious unfairness, or impossibility arguments were valid. The farm argued that terminating the contract or raising the rent is a means to prevent the dissipation of state assets, and the continued performance of the contract will affect the operation of the farm. Therefore, the court had to weigh the public policy of subsidizing a retiring SOE employee against the policy of preserving state assets. The court made the decision to prioritize the policy that is of greater assistance to the more vulnerable retiring SOE employee. The court reasoned that the farm has substantial financial capacity, while Teng was counting on the 4.82 mu farmland as the main source of his income.²⁶³ Also, the contract had been performed for ten years and only had five years remaining.²⁶⁴ The continued performance of contract would have only very limited impact on the farm.²⁶⁵ Therefore, the court upheld the validity of the contract terms and ordered the farm to continue the performance for the rest of the term.²⁶⁶

In another 2014 case, the validity of an asset purchase agreement was challenged when an SOE employee, Gao Wenjie, purchased RMB 6.67 million yuan worth of state assets at the price of RMB 3.66 million yuan.²⁶⁷ The SOE at the time, under the direction of the local government, was going through a restructuring process in which the SOE was sold to its employees.²⁶⁸ Gao acquired the state assets through an open bidding process under the supervision of the government.²⁶⁹ His purchase of the corporate assets and an equity interest were also affirmed by the government.²⁷⁰ The company and the other shareholders denied his equity interest, arguing to affirm the sale would be to encourage the stripping of state assets.²⁷¹ The court, however, affirmed the validity of the sale of the equity interest and the asset purchase agreement even though the price was lower than the

²⁶¹ *See id.*

²⁶² *See id.*

²⁶³ *See id.*

²⁶⁴ *See id.*

²⁶⁵ *See id.*

²⁶⁶ *See id.*

²⁶⁷ *See* 高文杰 v. 定西市熙海油脂有限责任公司 [Gao Wenjie v. Dingxi City Hee Sea Oil LLC] (Dingxi City Interm. People's Ct. 2014) (China). (2014) 定中民二初字第4号 [(2014) Ding Zhong Min Er Cu Zi No.4].

²⁶⁸ *See id.*

²⁶⁹ *See id.*

²⁷⁰ *See id.*

²⁷¹ *See id.*

market value.²⁷² The court reasoned that both parties agreed that the purpose of the asset transfer at the lower price was to implement the state policy of re-settling the former SOE employees after privatization.²⁷³ The *Provisional Rules on Transferring State Shares in Listed Companies by Holders of State Shares* allows holders of state shares to transfer their shares gratuitously to government agencies, public sector organizations, and wholly state-owned enterprises.²⁷⁴ Such transfers require a feasibility study, financial reports, legal opinions by law firms, development and restructuring plans, protocols to deal with the debts, and approval by the SASAC.²⁷⁵

VI. CONCLUSION

In the pre-reform Chinese economy when every business was owned by the state and no market competition was allowed, it made sense for the state to deprive enterprises of contractual and managerial autonomy. Freedom of contract was prohibited and the theories were geared towards the fairness of contracting to the collective system. Principles such as accommodation of each party's difficulties in contractual performance and loss splitting between the parties existed to lower the economic loss to the state. Also, Western doctrines of apparent authority and *ultra vires* were rejected. In China's pre-reform distorted economy, even to make a profit by reselling was regarded as illegal and punishable by penal law. Though the theories were coherent, the low efficiency and ineffective allocation of resources in the economy called for the reform of the state sector and the introduction of a private sector.

Unlike former Soviet countries, in reforming its economy, China did not implement massive privatization but rather introduced a private sector outside the state sector and invigorated the state sector gradually so it could compete with the private sector. Partial profit-related incentives and partial managerial and contractual autonomy were introduced to invigorate SOEs. However, the market was still not sufficiently competitive and profit alone does not serve as a sufficient indicator of performance. To date, SOEs still account for roughly half of the Chinese economy and state ownership is pervasive in virtually all industries, many of which do not serve public or policy interests. Market capitalization allows private investors to be the shareholders of large SOEs, while, in most circumstances, the state

²⁷² See *id.*

²⁷³ See *id.*

²⁷⁴ See 国有股东转让所持上市公司股份管理暂行办法 [The Provisional Rules on Transferring State Shares in Listed Companies by Holders of State Shares] art. 30 (China).

²⁷⁵ See *id.* art. 34.

maintains a controlling interest in virtually all major state enterprises. The controlling interest of the state is guaranteed by the fact that a majority of shares in the Chinese stock markets are not tradable. On the other hand, inefficient small and medium sized enterprises have been privatized in the name of restructuring. Regardless of ownership status, the lack of a competitive market will continue to allow conflicts of interest between the state and private investors and a conflict between incompatible incentives.

SOEs still carry out policy goals that are non-profit driven, and SOE managers make business decisions that are in alignment with their political responsibilities. Such decisions enhance the political legitimacy of the Communist Party of China and at the same time, serve to advance their bureaucratic careers. These decisions are not necessarily in the best commercial interest of the enterprises. Examples are managerial decisions to engage in major disaster relief efforts at the cost of the SOEs to gain political capital,²⁷⁶ overstaffing to lower the unemployment rates, providing essential services to the society at below market prices²⁷⁷ or listing overseas to attract political attention.²⁷⁸

As we can see in many post-reform cases, in the name of the preservation of State assets, the state or SOEs who have contracted with private investors shirk bad bargains that were fair upon conclusion of the contract. On the other hand, SOE managers, motivated by illegal self-interest, have sold off state assets or equity interests below the market values for the sole purpose of asset stripping. In these two scenarios, the expressed will of the SOEs is illegitimate and should not be honored. As a result, there are two conflicting tendencies in the decisions of courts. On one hand, courts have enlarged power to declare a contract void and give the SOEs a free way out of a bad bargain to safeguard the state's financial interest. On the other, invoking freedom of contract, courts have refused to examine the fairness of the contract price and whether the transaction was tantamount to asset-stripping even when the SOE manager was convicted of receiving bribery in selling the State assets.

Freedom of contract should be modified so that the will expressed by SOE managers does not have the binding force that it would receive in Western law when it does not serve the interest of SOEs, or shields an SOE

²⁷⁶ See Jiangyu Wang, *The Political Logic of Corporate Governance in China's State-owned Enterprises*, 47 CORNELL INT'L L.J. 631, 663-664 (2014).

²⁷⁷ See Justin Yifu Lin & Guofu Tan, *Policy Burdens, Accountability and Soft Budget Constraint*, 89 AM. ECON. REV. 2, 429 (1999).

²⁷⁸ See Mingyi Hung T.J. Wong & Tianyu Zhang, *Political Considerations in the Decision of Chinese SOEs to List in Hong Kong*, 53 J. OF ACCT. AND ECON. 435, 436-37, 445-48 (2012).

from the risks of contracting. Without a competitive market, any *ex ante* deterrent will not be effective without sufficient indicator of managerial performance. Logically, we will have to resort to *ex post* judicial review of the substantive fairness of a contract to determine whether the state asset has been stripped or freedom of contract has been abused by the state. Therefore, the victim of the illegitimate declaration of will should be able to sue to avoid it. Upon the request of the aggrieved SOE or private investors in an SOE, courts should reject their freedom of contract and declare the contracts void. An enhanced judicial scrutiny of substantive fairness of transactions should be introduced when the state circumvents freedom of contract to renege a bad bargain and when an SOE manager abuses his power to sell off state assets at a price that is tantamount to asset stripping. As a result, neither wills expressed by an SOE to shirk a bad bargain nor the wills expressed by an SOE manager to strip a state asset shall be valid.

These problems will continue to exist so long as the state maintains its dual role as a referee and a player. There will be a continual conflict of interest and incompatibility of incentives. The most effective solution would be to find an incentive compatible mechanism that would give state sufficient incentive to stay as a passive tax collector rather than a shareholder.

As in the Western experiment of government corporations, the state has the incentive to maximize its wealth through maximizing the wealth of enterprises that are fully or partially owned by the state. This could still be done by the state's administrative intervention. Even in the West, the state did not retreat from its active role as a shareholder role in mixed enterprises out of goodness of heart. The shift only occurred when state realized that its best interests were served by acting as an impartial tax collector rather than a biased shareholder.²⁷⁹ When this happens, freedom of contract, as in the West, might finally be applicable to China.

²⁷⁹ See generally Mariana Pargendler, *State Ownership and Corporate Governance*, FORDHAM L. REV. 2917, 2931 (2012).

**PUTTING ISIS OUT OF BUSINESS
FULLY LEVERAGING THE INTERNATIONAL EMERGENCY ECONOMIC
POWERS ACT TO MORE EFFECTIVELY COUNTER COMMODITY-SELLING
TERRORISTS**

*Bryan M. Burack**

I. INTRODUCTION

In early January 2016, the United States dropped two 2,000 pound bombs on a warehouse full of cash in Mosul, Iraq.¹ In the declassified video, clouds of money can be seen floating through the air after the massive explosion. This inelegant tactic, which the Department of Defense confirmed had been used before,² underscores one of the primary reasons that many say that ISIS, or the Islamic State, is the most formidable terrorist threat the world has ever seen.³ The Islamic State's physical brutality is not the only reason for the organization's resilience and tenacity. Rather, it is the Islamic State's massive wealth relative to other terrorist organizations, and its ability to generate funds in a manner that previous terrorist powers have not⁴, which the current U.S. counterterror finance toolkit is ill-equipped to deal with.⁵

The Islamic State ("IS") funds itself in a number of ways. Late 2015 reports estimated that the IS generated \$360 million or more annually from "taxes" collected from the 8 million civilians living in the purported caliphate, around \$500 million a year from oil sales, more than that from looting banks, and a few tens of millions from kidnappings for ransom.⁶ IS

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¹ Barbara Star & Daniella Diaz, *First on CNN: Pentagon Releases Video of U.S. Bombing 'Millions' in ISIS Cash*, CNN (Jan. 16, 2016), <http://www.cnn.com/2016/01/15/politics/us-bombs-isis-cash-money-iraq/>.

² *Id.*

³ Anne Gearan, *Clinton Says Islamic State Militants are Worse Than al-Qaeda*, THE WASH. POST (Oct. 8, 2014), http://www.washingtonpost.com/politics/clinton-says-islamic-state-militants-are-worse-than-al-qaeda/2014/10/08/20244a20-4f53-11e4-877c-335b53ffe736_story.html.

⁴ Raheem Salman & Yara Bayoumy, *Insight – Islamic State's Financial Independence Poses Quandary for Its Foes*, REUTERS (Sept. 11, 2014), <http://uk.reuters.com/article/2014/09/11/uk-iraq-crisis-militants-funding-insight-idUKKBN0H60AM20140911>.

⁵ See *infra* Section III.

⁶ Jose Pagliery, *Inside the \$2 billion ISIS war machine*, CNN (Dec. 11, 2015), <http://money.cnn.com/2015/12/06/news/isis-funding/>; *The Role of Oil in ISIL Finances*,

may also generate as much as \$100 million from pillaged historical antiquities, indicating a total annual funding of as much as \$1.2 billion.⁷ Of these sources, the oil trade presents a particularly difficult challenge in relation to IS and any future conflict with such a quasi-state because it presents a continuing source of income.

Precise details of the Islamic State's involvement in the oil industry are difficult to pin down, another factor that has troubled anti-IS forces,⁸ but even a general sense of its scope paints an alarming picture. Late 2015 reports estimate that the Islamic State sold about 40,000 barrels of oil per day, pulling in around \$1 million dollars every 24 hours.⁹ However, these numbers do not represent the full potential of the IS's oil business, as IS has been unable to reach the full production capacity of the fields it controls.¹⁰ The reason for the disparity is a present lack of technical expertise on the part of the jihadists; "it is doubtful the group has the technical capacity to run larger or more complex operations."¹¹ The majority of IS's oil trade comes from the sale of crude oil, rather than the finished product that comes out of a refinery;¹² "the Islamic State makes most of its money from crude oil, not from fuel refined from the oil."¹³

Hearing Before the S. Comm. on Energy and Nat. Res., 114th Cong. 3 (2015) [hereinafter *Crane Testimony*] (statement of Keith Crane, Senior Economist, Rand Corporation), <http://www.energy.senate.gov/public/index.cfm/2015/12/hearing-to-examine-terrorism-and-the-global-oil-markets>.

⁷ *Crane Testimony*, *supra* note 6, at 3.

⁸ Mark Thompson, *U.S. Bombing of ISIS Oil Facilities Showing Progress*, TIME (Dec. 13, 2015), <http://time.com/4145903/islamic-state-oil-syria/>.

⁹ *Id.*; see also Keith Johnson, *The Islamic State is the Newest Petrostate*, FOREIGN POLICY (July 28, 2014), http://www.foreignpolicy.com/articles/2014/07/28/baghdadis_hillbillies_isis_iraq_syria_oil_terrorism_islamic_state (reporting previous estimates);

Robert Schroeder, *Kidnappings and Oil Sales: How al Qaeda, Islamic State Reap Millions*, MARKETWATCH (July 20, 2014), <http://blogs.marketwatch.com/capitolreport/2014/07/30/kidnappings-and-oil-sales-how-al-qaeda-islamic-state-reap-millions/> (reporting previous estimates).

¹⁰ Indira A.R. Lakshman, *Islamic State Now Resembles the Taliban With Oil Fields*, BLOOMBERG BUS. (Aug. 25, 2014), <http://www.bloomberg.com/news/articles/2014-08-25/islamic-state-now-resembles-the-taliban-with-oil-fields>.

¹¹ Valérie Marcel, *ISIS and the Dangers of Black Market Oil*, CHATHAM HOUSE (July 21, 2014), <http://www.chathamhouse.org/expert/comment/15203>.

¹² Rebecca Collard & Greg Whitlock, *U.S. Says Airstrikes Crippled Most of Small Oil Refineries Held by Islamic State in Syria*, THE WASH. POST, (Sept. 25, 2014), <http://wapo.st/1ptFf95>.

¹³ *Id.*

This lack of advanced infrastructure in the Islamic State's oil business is, in some ways, an advantage for the quasi-state. Because IS bases its oil income generation on crude oil rather than a refined and finished product, it is less dependent on refineries, which present an easy target for airstrikes.¹⁴ The primitiveness and decentralization of the industry also help to deprive anti-IS forces of specific information needed to target military strikes without excessive civilian casualties, an issue that has been exacerbated by hesitation on the part of coalition forces to cripple future legitimate governments by destroying too much infrastructure.¹⁵ Recent intelligence successes have reportedly allowed the U.S.-led coalition to step up airstrikes targeting IS oil assets,¹⁶ and by early 2016 IS had lost control of valuable oil fields in Iraq, indicating a likely decline in their oil revenues.¹⁷ However, fiery rhetoric suggesting that airstrikes would cripple the jihadists has been circulated since early on in the anti-IS struggle.¹⁸

IS has made their black market oil an attractive purchase in a simple manner, namely, by selling it for a fraction of the present market rate. "The price the Islamic State group fetches for its smuggled oil is discounted — \$25 to \$60 for a barrel of oil that normally sells for more than \$100 — but its total profits from oil are exceeding \$3 million a day" according to a 2014 report.¹⁹

A barrel of oil that would ordinarily sell for over \$100 can be discounted as much as 75 percent. But it is still a profitable sale for IS, as the money it loses from such a discount is more than made up for by the readiness of customers to buy its oil and the plethora of routes through which it can export it.²⁰

The cheap, plentiful crude has attracted small-scale entrepreneurs to IS-controlled territory, who operate micro-refineries and have reportedly become the most important buyers of Islamic State crude.²¹ Conveniently

¹⁴ *Id.*

¹⁵ Thompson, *supra* note 8.

¹⁶ *Id.*

¹⁷ *Crane Testimony*, *supra* note 6, at 3.

¹⁸ Erin Banco, *US Airstrikes in Syria Cripple ISIS Funding by Hitting Oil Refineries*, THE INT'L BUS. TIMES (Sept. 30, 2014), <http://www.ibtimes.com/us-airstrikes-syria-cripple-isis-funding-hitting-oil-refineries-1696902>.

¹⁹ Ken Dilanian, *ISIS Became the Richest Terrorist Group Ever By Raising Money Like a Mafia*, BUS. INSIDER (Sept. 14, 2014), <http://www.businessinsider.com/isis-became-the-richest-terrorist-group-ever-by-raising-money-like-a-mafia-2014-9>.

²⁰ Chris Dalby, *Who Is Buying the Islamic State's Illegal Oil?*, OIL PRICE (Sept. 30, 2014), <http://oilprice.com/Energy/Crude-Oil/Who-Is-Buying-The-Islamic-States-Illegal-Oil.html>.

²¹ *Crane Testimony*, *supra* note 6, at 4-5.

for the Islamic State, the Iraq-Syria-Turkey border region it occupies is a decades-old smuggler's haven, the perfect territory for moving oil and other illicit goods from IS-controlled territory to international buyers.²² The Islamic State has cooperated with existing, established smuggling rings to move their products out of the conflict zone to international buyers.²³

IS exports its oil to buyers throughout the region. Turkey has been used as a gateway for foreign fighters joining the conflict,²⁴ and, in the late summer of 2014, IS brazenly built rudimentary oil pipelines directly into Turkey.²⁵ IS has also sold self-produced refined fuel publicly in Turkey, undercutting legitimate vendors with cutthroat prices.²⁶ Historically "Turkey has turned a blind eye to this and may continue to do so until they come under pressure from the West to close down oil black markets in the country's south."²⁷ Additionally, the Islamic State oil is transported to Jordan and Iran for black market sale, and is sold locally in Syria and Iraq.²⁸

The IS's illicit oil trade brings it benefits beyond simply generating cash. The oil revenue supports the Islamic State's nation building efforts, granting legitimacy to their self-imposed regime and helping to further ingrain the caliphate into the lands they have captured.²⁹ The Islamic State's strategy of tying itself to its captured land and establishing structures of government is a deliberate choice, as it is both a means of consolidating power and a source of funding.³⁰

The ability to self-finance distinguishes the Islamic State from other sophisticated terrorist organizations, allowing the Islamic State to be insulated from economic sanctions and other methods that have traditionally been used to counter terrorist finance.³¹ "[The] Islamic State has almost weaned itself off private funds from sympathetic individual donors in the Gulf. Such money flows have come under increased scrutiny from the U.S.

²² Dilanian, *supra* note 19.

²³ Dalby, *supra* note 20.

²⁴ See Ayla Albayrak & Joe Parkinson, *Turkey Struggles to Halt Islamic State 'Jihadist Highway'*, THE WALL STREET JOURNAL (Sept. 4, 2014), <http://www.wsj.com/articles/turkey-struggles-to-halt-islamic-state-jihadist-highway-1409777884>.

²⁵ Luay al-Khatteeb, *How Iraq's Black Market in Oil Funds ISIS*, CNN (Aug. 22, 2014), <http://edition.cnn.com/2014/08/18/business/al-khatteeb-isis-oil-iraq/>.

²⁶ Frances Martel, *Report: Turkey's Border Towns Provide a Welcoming Market for ISIS Oil*, BREITBART (Sept. 10, 2014), <http://cdn.breitbart.com/Big-Peace/2014/09/09/Report-Turkey-s-Border-Towns-Provide-a-Welcoming-Market-for-ISIS-Oil>.

²⁷ al-Khatteeb, *supra* note 25.

²⁸ Dalby, *supra* note 20; al-Khatteeb, *supra* note 25; *Crane Testimony*, *supra* note 6, at 5.

²⁹ Martel, *supra* note 26.

³⁰ *Id.*

³¹ Salman & Bayoumy, *supra* note 4.

Treasury.”³² These funds, which flow from wealthy individuals in other countries to terrorist bank accounts, are what the U.S. terrorist sanctions regime is designed to target. But, “[u]nlike other extremist groups’ reliance on foreign donations that can be squeezed by sanctions, diplomacy and law enforcement,” the Islamic State is independent from the international banking and finance systems.³³ Its “predominantly local revenue stream poses a unique challenge to governments seeking to halt its advance and undermine its ability” to launch attacks abroad,³⁴ an international reach that was displayed with horrific results in Paris in November of 2015. The resilience of this revenue stream is only made clearer by the fact that the U.S. was unable to effectively address IS oil sales without resorting to targeted bombing campaigns.³⁵ Like the unsubtle use of kinetic force against warehouses full of cash, the fact that this bombing campaign is the only tool the U.S. government had available raises the question of whether the U.S.’s economic warfare capabilities are as developed as they should be.

The resistance of the Islamic State to U.S. domestic economic sanctions authorities is the starting point of this piece. Below, it will first examine the current framework used to apply financial sanctions to terrorists. Then, the piece will explain that the legal framework that applies U.S. economic sanctions to terrorists is insufficient to counter terrorist quasi-states, such as the Islamic State, who fund themselves through the sale of commodities such as crude oil.³⁶ This examination of the sanctions regime will show that it currently punishes individuals or groups after they contribute to terrorist activity, but does not, as it should, implement sufficient deterrent measures to prevent such activities in the first place. Thus, the current legal framework of the U.S. sanctions regime is unsuited to deal with commodity-financed terrorists.

This paper will investigate the shortcomings of the current regime when applied to entities like the IS, and then suggest that the regime should be reworked to the limits of its authority to prevent illicit commodity sales before they are completed. A possible solution is to use the President’s

³² *Id.*

³³ Lakshman, *supra* note 9.

³⁴ *Id.*

³⁵ Thompson, *supra* note 8.

³⁶ The Department of the Treasury’s Office of Foreign Asset Control, the executive body charged with applying the U.S. government’s financial sanctions to the property of terrorists, blocked a total of just over \$22 million in 2013. In its most recent report detailing its actions against terrorist groups, the Office does not include a line item for the Islamic State. The Office’s responsibilities and place in the sanctions regime are discussed further below. See OFFICE OF FOREIGN ASSETS CONTROL, U.S. DEP’T OF THE TREASURY, TERRORIST ASSETS REPORT: CALENDAR YEAR 2013 (2013) [hereinafter TERRORIST ASSETS REPORT], <http://www.treasury.gov/resource-center/sanctions/Programs/Documents/tar2013.pdf>.

emergency commerce powers to alter the financial incentives in sectors where terrorist quasi-states operate, which could encourage financial actors not to trade with terrorists, and reinforce legitimate economies in sectors endangered by terrorist commerce. This proposal suggests implementing “carrots” in addition to “sticks” in the U.S. sanction strategy,³⁷ by leveraging the Executive branch’s emergency commerce powers to further disincentivize illicit trading and to reinforce legitimate economies in markets where terrorists are active. Through the use of targeted, tactical subsidies and other tools that the President of the United States could wield, the U.S. could better deprive terrorist quasi-states like the Islamic State of locally generated revenue.

II. BACKGROUND I: THE EXISTING LEGAL FRAMEWORK OF THE SANCTIONS REGIME

The legal framework currently used to apply financial sanctions to Islamic State and other terrorist entities consists of a composite of legislative authorization, legislative limitation, and executive action. The power is rooted in an enabling act, under which the president may mobilize the executive branch to control foreign finances in response to international emergencies. These powers, though broadly stated, are in turn constrained by another piece of legislation, which defines and limits such emergencies, bringing the legislative branch into the regime. Finally, in order to use the powers thus granted and constrained, the President issues executive orders detailing his implementation and delegation of the authority. The final result of this framework is the ability for the executive branch to designate entities as terrorists and to apply sanctions and other measures to them pursuant to this designation.³⁸

The foundation of the sanctioning power is the International Emergency Economic Powers Act (“IEEPA”). The IEEPA became law in 1977, and grants the President powers “to deal with any unusual and extraordinary threat, which has its source in whole or substantial part outside the United States, to the national security, foreign policy, or economy of the United States, if the President declares a national emergency with respect to such threat.”³⁹ The powers include the ability to “investigate, regulate, or prohibit... any transactions in foreign exchange,”

³⁷ David Cortright & George A. Lopez, *Bombs, Carrots, and Sticks: The Use of Incentives in Sanctions*, ARMS CONTROL ASS'N (Mar. 1, 2005), http://www.armscontrol.org/act/2005_03/Cortright.

³⁸ U.S. DEP'T OF STATE, TERRORISM DESIGNATION FAQs (Jan. 10, 2014) [hereinafter TERRORISM DESIGNATION FAQs], <http://www.state.gov/r/pa/prs/ps/2014/01/219520.htm>.

³⁹ 50 U.S.C. § 1701(a).

to investigate and control property transactions of foreign nations and nationals, and to confiscate the property of foreign nations or nationals that have taken part in hostilities against the United States.⁴⁰ The act contains explicit exemptions for transactions and property transfers relating to humanitarian aid⁴¹, and for communications and information transfer.⁴²

These powers, which could be seen as an alarmingly broad grant of power to the Executive, are constrained by the National Emergencies Act (“NEA”).⁴³ The President gains heightened authority and powers when he declares a national emergency; the economic powers of the IEEPA, discussed above, are some of these. In the NEA, the Legislature has reserved for itself a measure of review and control of such emergency powers⁴⁴. The NEA gives the Congress the authority to use a joint resolution to terminate national emergencies declared by the President, and mandates that Congress review such national emergencies every six months.⁴⁵ The NEA also specifies that a national emergency will terminate after one year unless the President notifies Congress that the emergency is to continue.⁴⁶ This time constraint enables the legislative branch to impose a check on the President’s emergency powers, preventing such powers from continuing indefinitely, or longer than legislative judgment considers necessary.

The NEA further requires that the President openly specify the law he is operating pursuant to. “[N]o powers or authorities made available by statute for use in the event of an emergency shall be exercised unless and until the President specifies the provisions of law under which he proposes that he, or other officers will act.”⁴⁷ The National Emergencies Act also mandates that both the President and any agents acting pursuant to his emergency powers keep records of orders, rules, regulations and proclamations issued during the emergency.⁴⁸ This information must be transmitted to Congress, along with details of any spending by the President pursuant to the emergency.⁴⁹

⁴⁰ 50 U.S.C. § 1702.

⁴¹ See also Robert E. O’Leary, *Improving the Terrorist Finance Sanctions Process*, 42 N.Y.U. J. INT’L L. & POL. 549, 564 (2010).

⁴² See 50 U.S.C. § 1702(b).

⁴³ 50 U.S.C. § 1601 *et seq.*

⁴⁴ O’Leary, *supra* note 41.

⁴⁵ 50 U.S.C. § 1622.

⁴⁶ 50 U.S.C. § 1622(d).

⁴⁷ 50 U.S.C. § 1631.

⁴⁸ 50 U.S.C. § 1641.

⁴⁹ *Id.*

Despite such significant legislative oversight, the IEEPA is nonetheless a considerable grant of power to the chief executive. In order to implement the expansive economic powers it grants, the IEEPA also gives the President the authority to “issue such regulations, including regulations prescribing definitions, as may be necessary for the exercise of the authorities granted by this chapter.”⁵⁰ These presidentially issued regulations come in the form of executive orders.⁵¹

Most relevant to this discussion is Executive Order 13224,⁵² the cornerstone of the contemporary counterterror sanctions listing process. Issued by President George W. Bush on September 23, 2001, the Order is the product of an administration responding quickly and pragmatically to the post-9/11 terrorist threat.⁵³ The Order is titled “Blocking Property and Prohibiting Transactions With Persons Who Commit, Threaten To Commit, or Support Terrorism.”⁵⁴ In the order, President Bush first explains that he is using his powers under the IEEPA and the NEA,⁵⁵ thus fulfilling the NEA requirement that the President cite the basis for his authority. Executive Order 13224 then moves on to President Bush’s formal declaration of a national emergency due to terrorist attacks, triggering his emergency powers.⁵⁶ Following this declaration, the remainder of the Order consists of functional regulations.⁵⁷

First and most importantly, the Order provides for asset freezes for persons determined to be terrorists, to have aided terrorists, or “to be otherwise associated with” such groups.⁵⁸ As such, the scope of this freeze is rather broad, and as it is worded, could easily apply to an individual or group who themselves have no terrorist connections. Order 13224 could, for example, theoretically extend to an unknowing business associate of an individual who had once sold something to a terrorist group.⁵⁹ The Order includes an appendix containing a list for persons to whom the asset control

⁵⁰ 50 U.S.C. § 1704.

⁵¹ 50 U.S.C. § 1631.

⁵² Blocking Property and Prohibiting Transactions With Persons Who Commit, Threaten To Commit, or Support Terrorism, 66 Fed. Reg. 49,079 (Sept. 23, 2001) [hereinafter Blocking Property].

⁵³ Aaron L. Schwartz, *National Security and the Protection of Constitutional Liberties: How the Foreign Terrorist Organization List Satisfies Procedural Due Process*, 3 PENN. ST. J.L. & INT'L AFF. 292, 295 (2014).

⁵⁴ *Id.*

⁵⁵ The President also cited other bases for his actions.

⁵⁶ Blocking Property, 66 Fed. Reg. at 49,079.

⁵⁷ *Id.*

⁵⁸ Blocking Property, 66 Fed. Reg. at 49,080.

⁵⁹ See Blocking Property, 66 Fed. Reg. at 49,079.

will initially apply⁶⁰; among them is listed Osama Bin Laden.⁶¹ The Order then provides for application to further individuals, delegating authorities to the Secretaries of State and the Treasury. Under the Order, the Secretary of State may designate as a terrorist any “foreign persons determined... to have committed, or to pose a significant risk of committing, acts of terrorism that threaten the security of U.S. nationals or the national security, foreign policy, or economy of the United States.”⁶² At the Department of State, individuals designated under E.O. 13224 are known as “Specially Designated Global Terrorists (“SDGTs”).”⁶³ The designation authority given to the Secretary of the Treasury is even more expansive, as he may designate anyone determined “to be owned or controlled by, or to act for or on behalf of” a terrorist individual or group, as well as persons found to “assist in, sponsor, or provide financial, material, or technological support for, or financial or other services to or in support of, such acts of terrorism or” terrorists, and anyone “otherwise associated with” them.⁶⁴ The Treasury’s Office of Foreign Asset Control (“OFAC”) keeps a comprehensive list of “Specially Designated Nationals,” (“SDNs”) which includes SDGTs as well as the targets of other sanctions programs.⁶⁵

Following a designation by either the Department of State or the Department of the Treasury, Treasury’s Office of Foreign Asset Control⁶⁶ is charged with implementing the asset freezes.⁶⁷ Pursuant to E.O. 13224, OFAC can extend its grasp to “all property and interests in property of

⁶⁰ O’Leary, *supra* note 41 (The complete list of individuals and groups is kept by OFAC).

⁶¹ Blocking Property, 66 Fed. Reg. at 49,082.

⁶² Blocking Property, 66 Fed. Reg. at 49,079.

⁶³ TERRORISM DESIGNATION FAQs, *supra* note 38 (The Secretary of State may also designate “Foreign Terrorist Organizations” (FTOs) under the Immigration and Nationality Act. The FTO designation is applicable to organizations, triggering U.S. immigration restrictions on members of such organizations, in addition to asset freezes like those of the SDGT designation); Office of Foreign Assets Control, *U.S. Department of the Treasury, Sanctions List*, <https://sdnsearch.ofac.treas.gov> (The Islamic State, under its numerous pseudonyms, is found on the OFAC SDN list under both FTO and SDGT designation. The focus of this paper is limited to the SDGT designation in the interest of (relative) brevity.).

⁶⁴ Blocking Property, 66 Fed. Reg. at 49,080.

⁶⁵ *Specially Designated Nationals (SDNs) and the SDN List*, U.S. DEP’T OF THE TREASURY, https://www.treasury.gov/resource-center/faqs/Sanctions/Pages/faq_lists.aspx#sdn (last visited Mar. 28, 2016). The Office of Foreign Asset Control’s comprehensive list also includes designees of numerous region-specific and other sanctions programs that may implicate terrorism but are not immediately applicable to the sanctions process being implemented against the Islamic State. See *Question Index*, OFFICE OF FOREIGN ASSETS CONTROL, U.S. DEP’T OF THE TREASURY, http://www.treasury.gov/resource-center/faqs/Sanctions/Pages/ques_index.aspx (last visited Mar. 28, 2016).

⁶⁶ O’Leary, *supra* note 41, at 553-54.

⁶⁷ TERRORISM DESIGNATION FAQs, *supra* note 38.

[designees] that are in the United States or that hereafter come within the United States, or that hereafter come within the possession or control of United States persons.”⁶⁸ E.O. 13224 gives OFAC the authority to freeze all terrorist assets within U.S. jurisdiction, blocking the owner from access, as well as preventing transactions involving such property.⁶⁹ Under the Executive Order, transactions made in the attempt to evade these sanctions are a crime.⁷⁰

The sum of these parts reflects a practical use of one facet of the Chief Executive’s powers. The terrorist sanctions regime outlined here shows a pragmatic process that is based in the President’s ability to regulate foreign commerce,⁷¹ is constrained by Congress,⁷² was delegated to appropriate executive Agencies,⁷³ and is currently at work capturing the assets of enemies of the United States.⁷⁴

III. THE INSUFFICIENCIES OF THE CURRENT SANCTIONS REGIME

In addition to granting the authority to the Departments of State and the Treasury to designate terrorists who would be sanctioned, E.O. 13224 contains an annex that lists 27 entities that would be the initial targets of sanctions under the Order.⁷⁵ This annex includes some of the most well-funded, infamous, and powerful terrorist individuals and groups in existence at the time of the Order’s execution, including Al Qaida, Osama Bin Laden himself, and numerous terrorist groups operating across the Middle East and North Africa.⁷⁶ Today, the “Specially Designated Nationals and Blocked Persons List” acts as a living, up-to-the-minute version of this annex. It now contains nearly 1,000 pages of Specially Designated Nationals and organizations, as well as oceangoing vessels and airplanes that have been involved in illicit activities.⁷⁷ The thorough diligence evident in the creation

⁶⁸ See *Blocking Property*, 66 Fed. Reg. at 49,079.

⁶⁹ *Frequently Asked Questions: Sanctions Compliance*, OFFICE OF FOREIGN ASSETS CONTROL, U.S. DEP’T OF THE TREASURY, https://www.treasury.gov/resource-center/faqs/Sanctions/Pages/faq_compliance.aspx#block.

⁷⁰ TERRORISM DESIGNATION FAQs, *supra* note 38.

⁷¹ 50 U.S.C. §§ 1601-1651.

⁷² *Id.* § 1621.

⁷³ See *Blocking Property*, 66 Fed. Reg. at 49,079.

⁷⁴ See TERRORIST ASSETS REPORT, *supra* note 36.

⁷⁵ See *Blocking Property*, 66 Fed. Reg. at 49,083.

⁷⁶ *Id.*

⁷⁷ *Specially Designated Nationals and Blocked Persons List*, OFFICE OF FOREIGN ASSETS CONTROL, U.S. DEP’T OF THE TREASURY (Mar. 22, 2016), <https://www.treasury.gov/ofac/downloads/sdnlist.pdf>.

of this list is admirable, and there is no doubt that the list has intrinsic value as a compendium of threats to international safety.

However, the comprehensiveness of the sanctions list has little relation to the efficacy of the sanctions program. The “listing process may be more about the idea that the government is doing something to stop the flow of money to terrorist organizations than it is about actually stopping that flow.”⁷⁸ OFAC currently blocks about \$22 billion.⁷⁹ The data is listed in the annual “Terrorist Assets Report” of 2013, the most recent available, which deals with a total of nine foreign terrorist organizations, and does not include the Islamic State.⁸⁰ The current listing process targets terrorist organizations that are funded in the traditional manner, by wealthy donors, and it has shown success in reducing the cash flow of organizations like Al Qaeda in the past.⁸¹ Though a sanctions listing can often become a *cause celebre* in the media,⁸² the practical effect of a listing in countering emerging forms of terrorist finance is suspect. Terrorist groups can dodge the effects of the financial freezes that a listing imposes by moving to alternative models of financing. For example, to avoid the initially punishing effects of the financial sanctions, Al Qaeda has since raised funds through its affiliates in cash generating operation such as kidnapping for ransom.⁸³ These transactions are immune to the model of sanctions used by the U.S., which can only block money flowing within the traditional financial system.

This present system has further shortcomings in relation to commodity-selling organizations like the Islamic State. The main challenge is that under the current system, an individual will have their assets frozen only after they are deemed by the United States’ Executive branch to be a terrorist, to have assisted a terrorist, or to be otherwise related to a terrorist. This means, for instance, that a buyer who may be interested in purchasing

⁷⁸ O’Leary, *supra* note 41, at 568.

⁷⁹ TERRORIST ASSETS REPORT, *supra* note 36, at 9.

⁸⁰ *Id.*; Previous OFAC Terrorist Asset Reports can be found at:

<http://www.treasury.gov/resource-center/sanctions/Programs/Pages/terror.aspx>. The lack of an entry for the Islamic State reflects both the organization’s incredibly rapid rise to prominence, as well as ongoing controversy regarding whether or not it can be considered a part of Al Qaeda.

⁸¹ Tim McGirk, *Could Osama bin Laden’s Death Bankrupt al-Qaeda?*, TIME (May 3, 2011), <http://content.time.com/time/world/article/0,8599,2069247,00.html>.

⁸² See, e.g., Samuel Rubinfeld, *US Labels ISIS Spokesman a Terrorist*, WALL ST. J. (Aug. 18, 2014), <http://blogs.wsj.com/riskandcompliance/2014/08/18/us-labels-isis-spokesman-a-terrorist/>.

⁸³ Rukmini Callimachi, *Paying Ransoms, Eawope Bankrolls Qaeda Terror*, N.Y. TIMES (July 29, 2014), <http://www.nytimes.com/2014/07/30/world/africa/ransoming-citizens-europe-becomes-al-qaedas-patron.html>.

oil products from the Islamic State has every opportunity to remove himself and his assets from the U.S. Treasury's reach before making such a purchase. Thus, the current framework used to designate and sanction individual entities is insufficient. It relies entirely on the post-hoc imposition of financial asset blocks to encourage potential buyers not to pursue the quite attractive discounts that a commodity-selling quasi-state like IS offers. This framework is ineffective because it is constrained to a limited jurisdictional reach that is easily evaded by its targets, because it does not properly target the funding sources of commodity-backed organizations like the Islamic State, and because its backwards-looking nature does not properly disincentivize the behaviors it should help to eradicate.

A. *The Current Sanctions Program Allows for Easy Evasion by its Targets Due to a Limited Jurisdictional Reach.*

Firstly, the U.S. domestic terrorist sanctions program is ineffective in addressing terrorist quasi-states because it allows for easy evasion. The Title of the OFAC Report, which is in part "Assets in the United States Relating to Terrorist Countries and International Terrorist Program Designees," demonstrates part of this structural inadequacy of the sanctions program.⁸⁴ Despite bearing the name 'Office of *Foreign* Assets Control,' it is critical to understand that, in relation to terrorist assets, OFAC can only block monies or properties that are kept within the United States, or with a U.S. company or bank that operates aboard.⁸⁵ They are thus limited in their reach by E.O. 13224, which restricts the blocking powers it grants to transactions "by United States persons or within the United States."⁸⁶

Terrorists and those who deal with them are not likely to keep assets in the United States in the first place, nor use a U.S. corporation to conduct transactions internationally. Entities like the Islamic State are insulated from the international financial network and thus largely immune to these kinds of sanctions.⁸⁷ But, even if operating within the international financial system, a potential target of the sanctions program would have ample opportunity to avoid the sting of asset blocking. Because the sanctions only

⁸⁴ TERRORIST ASSETS REPORT, *supra* note 36.

⁸⁵ *About*, OFFICE OF FOREIGN ASSETS CONTROL, U.S. DEP'T OF THE TREASURY (Feb. 26, 2016, 11:15 AM), <http://www.treasury.gov/about/organizational-structure/offices/Pages/Office-of-Foreign-Assets-Control.aspx>.

⁸⁶ See Blocking Property and Prohibiting Transactions With Persons Who Commit, Threaten To Commit, or Support Terrorism, 66 Fed. Reg. 49,079 (Sept. 23, 2001).

⁸⁷ Alan Einisman, *Ineffectiveness at Its Best: Fighting Terrorism with Economic Sanctions*, 9 MINN. J. GLOBAL TRADE 299, 310-12 (2000).

apply after one is deemed a terrorist or transacts with them, the target can remove his interests from the U.S., or conclude his dealings with a U.S. foreign subsidiary, before doing whatever actions might trigger the sanctions. As the regime applies only post-hoc measures, a given target has all the time they may need to make preparations to avoid the sanctions.

Because these measures only block access to funds after an illicit transaction has already occurred, U.S. sanctions are limited in effect to the extent to which they are enforced abroad.⁸⁸ Such measures, despite their backwards looking nature, are more effective if they are part of a multilateral effort; the fewer jurisdictions a terrorist's assets are free in, the more effective these sanctions would become.⁸⁹ A U.N.-led or organized effort could thus turn this kind of post-hoc sanctions regime into a more effective tool than if an individual state were to do so unilaterally.⁹⁰ However, a multilateral sanctions regime comes with its own challenges. The U.N. maintains its own list of terrorists, built with recommendations from the U.S. and other states,⁹¹ and its current counterterrorism finance regime directs all member states to apply asset freezes and other measures, creating an ostensibly uniform multilateral system.⁹² However, the U.N. leaves enforcement to each member state; "[t]he primary responsibility for the implementation of the sanctions rests with the member states."⁹³ Such a system might be easily undermined, as a single noncomplying member state, allowing illicit terrorist commerce, would undermine the efforts of the others.⁹⁴ Such a scenario has, to some extent, already been seen in the

⁸⁸ Joseph M. Myers, *The Silent Struggle Against Terrorist Financing*, 6 GEO. J. INT'L AFF. 33, 36-37 (2005); See also Richard N. Haass, *Economic Sanctions: Too Much of a Bad Thing*, BROOKINGS POLICY BRIEF SERIES (June 1998), <http://www.brookings.edu/research/papers/1998/06/sanctions-haass> (finding that unilateral sanctions are rarely effective).

⁸⁹ See George A. Lopez, *Effective Sanctions: Incentives and UN-US Dynamics*, HARVARD INT'L REV., Fall 2007, at 50, http://csis.org/files/attachments/130828_Effective%20Sanctions.pdf (sanctions must be multilateral to be effective).

⁹⁰ Einisman, *supra* note 87.

⁹¹ See Somini Sengupta & Eric Schmitt, *U.S. asks U.N. to Add Names to Sanctions List*, N.Y. TIMES (Sept. 22, 2014), http://www.nytimes.com/2014/09/23/world/middleeast/un-may-add-names-to-blacklist.html?_r=0.

⁹² S.C. Res. 1267 (Oct. 15, 1999).

⁹³ *General Information on the Work of the Committee, ISIL (DA'ESH) & AL-QAIDA SANCTIONS COMMITTEE*, <https://www.un.org/sc/suborg/en/sanctions/1267/general-information> (last visited Mar. 28, 2016).

⁹⁴ See UNITED NATIONS COUNTER-TERRORISM IMPLEMENTATION TASK FORCE, TACKLING THE FINANCING OF TERRORISM 7 (2009), http://www.un.org/en/terrorism/ctitf/pdfs/ctitf_financing_eng_final.pdf (advocating international cooperation).

Islamic State's brazen and public commodity sales.⁹⁵ The challenges of limited jurisdiction for counterterror finance programs are thus seen in the context of multilateral programs as well, as states with robust counterterror agendas might be reliant on less motivated or capable allies to enforce the regime.⁹⁶

B. The Current Terrorist Sanctions Regime Is Not Properly Targeted To Counter Quasi- States Financed Through Commodity Sales.

Secondly, the sanctions do not do enough damage to the terrorists' primary sources of funding, especially in relation to a self-funded organization like the Islamic State.⁹⁷ Because the Islamic State raises funds internally, it is not reliant on donations from abroad and thus is insulated from the traditional model of counterterror financial sanctions designed to block such transfers,⁹⁸ even if these sanctions were part of a unified, global, and multilateral effort. The "Islamic State is essentially self-financing; it cannot be isolated and cut off from the world because it is intimately tied into regional stability in a way that benefits not only itself, but also the people it fights."⁹⁹

The Islamic State is not a typical nation state that is vulnerable to the traditional model of state-to-state economic sanctions.¹⁰⁰ Along with its terrorist peers and predecessors, IS raises funds through nefarious means that are immune to traditional counterterror sanctions.¹⁰¹ IS makes a brisk business of kidnapping for ransom, making as much as \$18 million from an individual ransom exchange.¹⁰² Such organizations also raise funds through

⁹⁵ See Mustafa Akyol, *The Truth About Turkey and Islamic State Oil*, AL MONITOR (Sep. 22, 2014), <http://www.al-monitor.com/pulse/originals/2014/09/turkey-iraq-syria-krg-isis-oil-hostages.html#>.

⁹⁶ A more thorough treatment of the U.N. counterterror sanctions program is beyond the scope of this piece.

⁹⁷ Julie Hirschfeld, *Treasury Imposes Terrorism Sanctions*, N.Y. TIMES (Sept. 24, 2014), <http://www.nytimes.com/2014/09/25/world/middleeast/treasury-imposes-terrorism-sanctions-on-those-linked-to-islamic-state.html>.

⁹⁸ *US Imposes Anti-Terror Financial Sanctions on 21 Individuals, 3 Companies*, RT (Sept. 25, 2014) [hereinafter *US Imposes Anti-Terror Sanctions*], <http://rt.com/business/190516-us-counter-terrorism-sanctions-isis/>.

⁹⁹ Michael Stephens, *Islamic State: Where does jihadist group get its support?*, BBC (Sept. 1, 2014), <http://www.bbc.com/news/world-middle-east-29004253>.

¹⁰⁰ Einisman, *supra* note 87, at 302.

¹⁰¹ *US Imposes Anti-Terror Sanctions*, *supra* note 98.

¹⁰² Ashley Lindsey, *In Syria, Militants Revive Kidnapping for Ransom*, STRATFOR (May 21, 2014), <http://www.stratfor.com/weekly/syria-militants-revive-kidnapping-ransom#axzz3Fn1Pe7pf>.

transnational sale of drugs.¹⁰³ While the post-hoc sanctions model may stop the rest of an individual's money from being withdrawn from a bank after he has given a ransom payment to IS, it cannot stop the hard currency gained from that payment from supporting IS. Because the current post-hoc terrorist sanctions program only operates to restrict transactions occurring in the legitimate economy, it is powerless to prevent these moneymaking activities.¹⁰⁴

In the case of the Islamic State, these other activities only supplement the quasi-state's main sources of income: the sale of oil.¹⁰⁵ Commodity sales, unlike the *per se* illegal activities mentioned above, kidnapping and drug dealing, generally occur in the legitimate economy. Such exchanges of goods for money might perhaps be vulnerable to a comprehensive multilateral asset blocking sanctions regime, especially if they occur across national boundaries.¹⁰⁶ However, the Islamic State's commodity sales do not occur in the legitimate economy. They sell small quantities of products to individual buyers and businesses.¹⁰⁷ There are no tax records or other paper trails to follow to determine whom to target with asset blocks, even if a nation with jurisdiction decided to assist the U.S. carry out its sanctions.

C. The Failure to Properly Target the Income Sources of Commodity-Financed Terrorist Quasi-states Reflects the Miscalibrated Incentive Structure of the Regime

Thirdly, the incentive calibration of the U.S. asset blocking sanctions program is off, failing to optimally disincentivize the types of activities it acts against, namely terrorist activity and transacting with terrorists. Positive incentives can be more effective than punitive sanctions in

¹⁰³ Johnson, *supra* note 9.

¹⁰⁴ See Jamsheed K. Choksy, "Crippling" Sanction will Still Be Ineffective, FOREIGN POLICY (Aug. 4, 2009), http://www.foreignpolicy.com/articles/2009/08/04/crippling_iran_sanctions_will_still_be_ineff (advocating precisely targeted sanctions regime for better results and less collateral effects). See also Charlie Savage and Mark Landler, *Black Market Shows Iran Can Adapt to Sanctions*, N.Y. TIMES (Oct. 4, 2009), <http://www.nytimes.com/2009/10/05/world/middleeast/05sanctions.html>.

¹⁰⁵ Jay Solomon, *U.S., Allies Step Up Efforts to Choke Off Islamic State's Funding*, THE WALL ST. J. (Sep. 9, 2014), <http://online.wsj.com/articles/u-s-allies-step-up-efforts-to-choke-off-islamic-states-funding-1410307008>.

¹⁰⁶ Lopez, *supra* note 89.

¹⁰⁷ *Turkey oil smugglers say crackdown aimed at punishing Islamic State group has ended boom times*, ASSOCIATED PRESS (Oct. 6, 2014), available at: <http://www.foxnews.com/world/2014/10/06/turkey-oil-smugglers-say-crackdown-aimed-at-punishing-islamic-state-group-has/>.

accomplishing foreign policy goals.¹⁰⁸ The U.S. sanctions program punishes by restricting access to the legitimate economy, by blocking assets that move in the legitimate economy.¹⁰⁹ However, the targets of this program, the terrorists and their customers, by their nature demonstrate that they neither desire to operate in the legitimate economy, nor are financially reliant on doing so.¹¹⁰ An Islamic State terrorist trading hostages for cash is not reliant on the legitimate economy. The small Turkish business owner who buys cheap Islamic State fuel is deliberately going outside the legitimate economy for a better deal. The sanctions program does not incentivize potential customers to act within the legitimate economy and to avoid buying commodities from terrorists. It punishes its targets by taking away access to a network that they did not want to begin with.¹¹¹

IV. MOVING TOWARD A PROACTIVE AND TARGETED SOLUTION

The U.S. terrorist sanctions program is ineffective when dealing with terrorist quasi-states who fund their activities through the sale of commodities they obtain by maintaining control over resource-rich territory.¹¹² The program operates by utilizing the President's ability to regulate foreign transactions under the IEEPA pursuant to national emergencies as defined by the NEA.¹¹³ President Bush issued E.O. 13224, which gives the Departments of State and the Treasury the authority to block terrorist funds but limits its jurisdiction to the U.S. and U.S. persons.¹¹⁴ The sanctions regime does not effectively constrain terrorist ability to generate funding because of this jurisdictional restriction, and because it is improperly targeted and calibrated to effectively address commodity funded terrorists.¹¹⁵

In order to more effectively counter terrorist quasi-states like the Islamic State who fund their activities through the sale of oil and like goods, the U.S. counterterror finance programs should make use of the most expansive jurisdiction possible, should directly target the transactions that generate profit for the terrorist quasi-state, and should properly incentivize transacting parties to conduct their business in the legitimate economy

¹⁰⁸ Cortright & Lopez, *supra* note 37.

¹⁰⁹ *Frequently Asked Questions: Sanctions Compliance*, *supra* note 69.

¹¹⁰ Johnson, *supra* note 9.

¹¹¹ Cortright & Lopez, *supra* note 37.

¹¹² See discussion *supra* Section I.

¹¹³ See discussion *supra* Section II.

¹¹⁴ See discussion *supra* Section II.

¹¹⁵ See discussion *supra* Section III.

rather than dealing with terrorists in the black market.¹¹⁶ As investigated below, some bases for these changes already exist in the legal framework of the current sanctions program.

V. THE FULL EXTENT OF THE POWERS GRANTED IN THE IEEPA

A. *A Comparison of the Jurisdictional Grants of the IEEPA and E.O. 13224*

An examination of the text of the International Emergency Economic Powers Act, when compared with President Bush's Executive Order 13224, which effectuates the powers granted by the IEEPA, reveals significant differences in the jurisdictional provisions of the two documents. The IEEPA grants the President emergency economic powers over “any transactions... by any person, or with respect to any property, subject to the jurisdiction of the United States.”¹¹⁷ This jurisdictional statement is clearly intended to give the President the fullest jurisdiction possible. The words grant to the President the most extensive jurisdiction available to the United States—the President’s jurisdiction under the IEEPA extends to the outermost fringes of possible U.S. jurisdiction.¹¹⁸

The jurisdictional grant of Executive Order 13224 does not echo these words.¹¹⁹ In the Order, President Bush provides for the blocking of “property and interests in property... that are in the United States or that hereafter come within the United States, or that hereafter come within the possession or control of United States persons.”¹²⁰ Though, for practical purposes, these extensions of jurisdiction are similar – as there may be little that the U.S. can exercise jurisdiction over that is not in the U.S. or held by a U.S. person – they are not the same.

While the IEEPA jurisdiction extends to the entirety of U.S. jurisdiction, and therefore would automatically integrate any extensions of the United States’ jurisdiction, the E.O. 13224 jurisdiction would not.¹²¹ The IEEPA jurisdiction is based on a statement of expansive words, designed to grant the widest possible jurisdiction. The E.O. 13224 statement restricts jurisdiction to explicit bounds, though it may nonetheless currently cover everything in the IEEPA jurisdiction. The key difference is that if

¹¹⁶ Cortright & Lopez, *supra* note 37.

¹¹⁷ 50 U.S.C. § 1702.

¹¹⁸ *Id.*

¹¹⁹ *See* Blocking Property, 66 Fed. Reg. 49,079.

¹²⁰ *Id.*

¹²¹ *Compare* 50 U.S.C. § 1702 *with* Blocking Property, 66 Fed. Reg. at 49,079.

there is any new development in U.S. jurisdiction, if it could somehow be extended or expanded to cover offshore transactions without a U.S. nexus as it is seen currently, for example, the jurisdiction under the IEEPA would automatically extend but the jurisdiction of the executive order would not. Thus, the words used to draft E.O. 13224's jurisdictional breadth fail to leverage the full extent of the jurisdiction provided by the IEEPA.

B. The Abilities Granted to the President Under the IEEPA

The existing sanctions regime is a system that blocks, sequesters, and prevents transactions of assets and property interests.¹²² The system takes things away from those it targets, but does not have a component that bestows positive rights.¹²³ It regulates transactions by prohibiting the use and exchange of interests, but does not regulate by coercion, by encouraging parties to transact in a given manner.¹²⁴ Though the regime currently only functions in one of the former modes, the legal basis for the sanctions regime gives it the ability to do both.¹²⁵

Executive Order 13224 operates by blocking “all property and interests in property” of certain persons, namely those determined to be terrorists, to aid terrorists, or to be otherwise related to them.¹²⁶ The Order also prevents transactions of these blocked assets.¹²⁷ Essentially, it blocks assets and prohibits transactions.¹²⁸ The IEEPA however, which is the basis of the EO's authority, provides the President with the ability to do more than this.¹²⁹ The IEEPA grants the ability to “investigate, regulate, or prohibit ... any transactions in foreign exchange...”¹³⁰ The use of the disjunctive “or,” and the inclusion of the word “prohibit” as a separately listed power indicates that the word “regulate” grants a separate power — that the President may do more than simply prohibit and block transactions and funds.

¹²² *Frequently Asked Questions: Sanctions Compliance*, *supra* note 69.

¹²³ *See* Blocking Property 66 Fed. Reg. 49,079.

¹²⁴ *Frequently Asked Questions: Sanctions Compliance*, *supra* note 69.

¹²⁵ *Compare* 50 U.S.C. § 1702 with Exec. Order No. 13,224, 66 Fed. Reg. 49,079 (Sept. 25, 2001).

¹²⁶ *See* Blocking Property, 66 Fed. Reg. 49,079 § 1 (Sept. 25, 2001).

¹²⁷ *Id.* at § 2.

¹²⁸ TERRORIST ASSETS REPORT, *supra* note 36, at 2-3.

¹²⁹ Blocking Property, 66 Fed. Reg. at 49,079.

¹³⁰ 50 U.S.C. § 1702(a)(1)(A)(2001).

VI. BETTER COUNTERING TERRORIST FINANCE BY MAKING FULL USE OF IEEPA AUTHORITY

To degrade the Islamic State's oil empire, the United States was forced to turn to kinetic force,¹³¹ because no other tools were available. This is partly due to the limited effectiveness of current domestic sanctions authorities in constraining terrorist quasi-state financing.¹³² These powers should be improved by fully leveraging the authority the Legislative branch has granted to the Executive in this realm, to better constrain the revenue generation of entities like the Islamic State. Such entities' ability to self-finance makes them particularly resilient to traditional sanctions measures,¹³³ which are designed to cut organizations off from the global financial markets,¹³⁴ and which are more effective against organizations financed by wealthy international donors, as many terrorist organizations were in the recent past.¹³⁵ To do this, the President could use the full scope of his international power to "regulate" transactions by applying tactical, targeted subsidies to certain commodities markets. This tactic would increase the ability of the U.S. to counter terrorists who self-finance through commodity sales such as the Islamic State.

A. Greater Powers and Jurisdiction Than Are Currently Leveraged

The IEEPA, by its language is designed to give the President broad international powers¹³⁶ that are currently not fully used in the current sanctions regime, could be the basis for the Executive's application of targeted subsidies abroad. The current sanctions regime neither makes full use of the President's authority nor operates to the full extent of its jurisdictional limits.¹³⁷ The IEEPA states that the President may regulate "any transactions in foreign exchange."¹³⁸ The broadness and scope of this grant should not be understated. With this grant of authority, Congress authorized the President to use his discretion to take almost any action in international finance.¹³⁹

¹³¹ Thompson, *supra* note 8.

¹³² See Salman & Bayoumy, *supra* note 4.

¹³³ Hirschfeld, *supra* note 97.

¹³⁴ Salman & Bayoumy, *supra* note 4.

¹³⁵ *Id.*

¹³⁶ See generally Blocking Property, 66 Fed. Reg. 49,079 (Sept. 23, 2001).

¹³⁷ Compare 50 U.S.C. § 1702, with Blocking Property, 66 Fed. Reg. at 49080-81.

¹³⁸ 50 U.S.C. § 1702(a)(1)(A)(i).

¹³⁹ Note: The President's powers under the IEEPA are nonetheless subject to the NEA and thus Congress maintains a check on these economic powers.

The only constraint written into the IEEPA is that the President's powers may only apply to transactions "subject to the jurisdiction of the United States."¹⁴⁰ In making this law, Congress did not intend for such jurisdiction to end at America's shores. It bears repeating that the name of the authority at issue is the "*International Emergency Economic Powers Act*,"¹⁴¹ (Emphasis added) to "be exercised to deal with any unusual and extraordinary threat, which has its source in whole or substantial part outside the United States, to the national security, foreign policy, or economy of the United States, if the President declares a national emergency with respect to such threat."¹⁴²

*B. Using the Powers and Jurisdiction Available to Apply Targeted Subsidies*¹⁴³

The President, through his Executive agencies, could thus use the powers granted to him to apply targeted subsidies internationally in response to terrorist threats or other emergencies. In the context of the example at issue in this piece, the Islamic State, a potential strategy could be as follows.

The program could be promulgated by executive order pursuant to the IEEPA and the NEA, and administered by an executive agency, one with familiarity with the Islamic State's sale of oil, such as the Department of Defense, the State Department, the United States Agency for International Development, the Treasury, or some combination of the above. The agency could target regions in which the Islamic State is selling its ill-gotten oil, and use targeted subsidies to manipulate the price of oil products. There are many ways in which this could be implemented, for example, through vouchers provided to buyers at risk of becoming IS customers, or through direct subsidization of mid-size oil suppliers, IS's undercut competitors.

This proposal would more effectively accomplish the sanctions program's goal – limiting the capital generation ability of terrorists, for numerous reasons. First, it would incorporate positive incentives to encourage parties not to deal with terrorists in the first place, an element

¹⁴⁰ 50 U.S.C. § 1702(a)(1)(B).

¹⁴¹ 50 U.S.C. § 1701(1977).

¹⁴² § 1701(a).

¹⁴³ Note: This paper deals predominantly with the possibility of the legal authority to institute such a program and the potential benefits it could offer. Funding, conflicts of law, and a deep investigation of the economic viability of such subsidies are outside the scope of this paper.

that is lacking in the current regime.¹⁴⁴ For a terrorist quasi-state dependent on buyers of its commodities, reducing the number of parties willing to buy their goods will reduce their ability to generate funding.¹⁴⁵ The positive incentives, subsidies for legitimate oil, would work in concert with the existing system's negative incentives, the asset freezes and the military's kinetic options, forming a more comprehensive and complete system that could better constrain the Islamic State's revenue generation by using more of the available tools.¹⁴⁶

Incentivizing potential buyers to avoid dealing with the Islamic State, and to remain in the legitimate local economy, will have beneficial effects on that local economy, as more transacting parties and more money would remain in the formal system.¹⁴⁷ Symbiotically, a stronger local economy will also serve the ends of a counterterror finance program, as prospective buyers of terrorist goods are less willing or less incentivized to go to the black market to make transactions.¹⁴⁸ A more empowered local economy could also counteract the Islamic State's tactic of consolidating power by controlling real estate, helping to ensure that they remain a fringe group and preventing them from becoming the law of the land, as they have in within their *de facto* borders.¹⁴⁹

Such a program could be quick to implement, effective, and efficient in terms of dollars spent, especially when compared to traditional methods of fighting terrorism.¹⁵⁰ Targeted subsidies injected on a local level could drive the Islamic State out of a given market very quickly, as the total amount of product they produce is paltry when compared to legitimate industrial operations.¹⁵¹ If all local buyers decide to buy their monthly oil from the legitimate market at a subsidized price, for example, there would be no buyers left in that locality to purchase the Islamic State's products.¹⁵² And even if, due to some unforeseen circumstances, such a program were unable to efficiently remove the Islamic State's oil from a given market,

¹⁴⁴ Cortright & Lopez, *supra* note 37.

¹⁴⁵ Akyol, *supra* note 95.

¹⁴⁶ Cortright & Lopez, *supra* note 37.

¹⁴⁷ See U.S. DEP'T OF THE ARMY, INSURGENCIES AND COUNTERING INSURGENCIES 4-33 (2014), http://armypubs.army.mil/doctrine/DR_pubs/dr_a/pdf/fm3_24c1.pdf.

¹⁴⁸ *Id.*

¹⁴⁹ O'Leary, *supra* note 41 at 575.

¹⁵⁰ See Mark Thompson, *The \$5 Trillion War on Terror*, TIME (June 29, 2014), <http://nation.time.com/2011/06/29/the-5-trillion-war-on-terror/>.

¹⁵¹ David E. Sanger & Julie Hirschfeld Davis, *Struggling to Starve ISIS of Oil Revenue, U.S. Seeks Assistance From Turkey*, N.Y. TIMES, (Sept. 13, 2014), <http://www.nytimes.com/2014/09/14/world/middleeast/struggling-to-starve-isis-of-oil-revenue-us-seeks-assistance-from-turkey.html>.

¹⁵² See Salman & Bayoumy, *supra* note 4.

simply making the offer to subsidize would have a powerful effect by itself – simply offering the subsidy would drive prices down. In order to keep selling its goods, the Islamic State would have to further undercut the price supported by the counterterror finance program. Then, even if every buyer still chooses to purchase from the Islamic State, the program has nonetheless reduced the amount of money obtained by the terrorists because they were forced to reduce their prices to undercut the subsidy.¹⁵³

Finally, such a program also has the advantage of being in line with principles of morality, and would not risk further civilian or military lives. Other methods of diminishing the commercial capacity of an entity like the Islamic State generally involve varying degrees of violence. Such scenarios carry the risk of death on both sides, as well as on the part of innocent third parties. A more effective and complete counterterror finance program could mean that less direct military action is needed, saving money and preserving lives.

VII. CONCLUSION

The Islamic State's unprecedented level of financial resources¹⁵⁴ and the unique characteristics of its self-financing scheme¹⁵⁵ are central to the Islamic State's intractability. The current models of counterterror finance, based on sanctions that apply only negative incentives as their functional components,¹⁵⁶ are poorly suited to counter the Islamic State and similar organizations.¹⁵⁷ Therefore, these models should be supplemented with further tools to provide a more complete toolkit for countering terrorist quasi-states that are isolated from the international financial system and self-finance through commodity sales.¹⁵⁸ Specifically, targeted subsidies that undermine commodity-selling terrorists could be a valuable tool. In addition to further examination of unused counterterror financial authorities, additional research in this area should be conducted regarding the legality of offering economic subsidies in foreign countries as a jurisdictional question, as well as the short- and long-term economic viability of such an undertaking.

¹⁵³ As an aside, in this scenario, the group implementing the sanctions as part of the counterterror finance program has actually spent nothing on the subsidies – simply making the offer created an effect.

¹⁵⁴ Scott Bronstein & Drew Griffin, *Self-funded and Deep-Rooted: How ISIS Makes its Millions*, CNN, (Oct. 7, 2014), <http://www.cnn.com/2014/10/06/world/meast/isis-funding/>.

¹⁵⁵ *Id.*

¹⁵⁶ TERRORISM DESIGNATION FAQs, *supra* note 38.

¹⁵⁷ Lopez, *supra* note 89, at 50.

¹⁵⁸ *US Imposes Anti-Terror Sanctions*, *supra* note 98.

**CRISIS IN THE PERSIAN GULF: THE PATH FOR REFORMING QATAR'S
COUNTERTERRORISM FINANCING REGIME**

*Alex M. Jensen **

“Good governance in any country is made by justice, honesty, and good example. God has said in the Holy Quran: ‘Allah commands you to render back the trusts to those to whom they are due and that when you judge between men you judge with justice.’”-His Highness Sheikh Tamim bin Hamad al-Thani, Emir of Qatar

The State of Qatar sits in the heart of the Persian Gulf at a crossroads between Asia, Africa, and Europe.¹ Despite a population of little more than 2 million people,² this unassuming desert sheikdom has utilized its strategic advantages under the hereditary rule of its Emir to assert a powerful international presence in the 21st Century.³ At the same time, in one of the continuing realities of the War on Terror, this tiny yet influential state has become an enduring center of terrorism financing activity in the Middle East.

The terrorist attacks on September 11, 2001 led the U.S. Treasury Department to focus efforts on identifying and sanctioning lax financial sectors utilized by groups like al-Qaeda, particularly in the Persian Gulf.⁴ The U.S. government sought to pressure foreign governments to crack down on terrorism financing channels via sanctions and tough domestic anti-funding laws.⁵ Qatar, like other Persian Gulf states, complied with

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¹ UNITED STATES CENTRAL INTELLIGENCE AGENCY, *THE WORLD FACT BOOK* 565-66 (2014 ed. 2013) (including a map of Qatar's geographic location in the Arab Peninsula) [hereinafter *THE WORLD FACT BOOK*].

² *Id.*

³ MEHRAN KAMRAVA, *QATAR: SMALL STATE, BIG POLITICS* 24 (Cornell University Press, 1st ed. 2015) (stating “the Persian Gulf is emerging as the new center of gravity of the Middle East because of its energy reserves and its financial resources”).

⁴ See John Waszak, *The Obstacles to Suppressing Radical Islamic Terrorist Financing*, 36 *CASE W. RES. J. INT'L L.* 673, 678 (2004).

⁵ See David Cohen, *Disrupting Terrorist Financing Networks: The U.S. Treasury and Its Partners*, 7 *YALE J. INT'L AFF.* 44, 46-47 (2012).

international pressure by toughening its domestic regulations with the 2010 Combatting Money Laundering and Terrorist Financing Law.⁶

Despite significant improvements in financial oversight in other Arab states, the U.S. government and international organizations continue to view Qatar's legal regime as lacking.⁷ In a rare diplomatic break, concerns over Qatar's lax financial environment led Saudi Arabia, the United Arab Emirates, and Bahrain to temporarily withdraw their ambassadors from the Qatari capital of Doha in 2013 in protest.⁸ With the advances of the Islamic State in Syria and Iraq, Qatar has come under increasing scrutiny for the failure of its legal regime to clamp down on terrorism related financial activity.⁹ Over a decade into the War on Terror and after passage of major reform legislation, the question becomes why Qatar, a key American ally in the region, continues to be what the U.S. State Department labels "a permissive environment for terrorist financing."¹⁰

This article will posit that the problem stems not from the drafting of Qatar's counterterrorism financing laws, but rather in their enforcement.¹¹ The development of Qatar's unique judicial system, independent from the influence of the executive branch, has created a passive legal regime that disincentivates the enforcement of the law.¹² Compared to its Gulf neighbors, Qatar's legal system has weakened the Emir's influence over the judicial complex and limited the executive's ability to ensure the enforcement and prosecution of counterterrorism laws.¹³ In effect, this has

⁶ See generally *Country Reports on Terrorism 2013-Qatar*, U.S. DEP'T OF STATE (April 30, 2014), <http://www.refworld.org/docid/536229c613.html>.

⁷ Lori Boghardt, *The Terror Funding Disconnect with Qatar and Kuwait*, THE WASH. INST. FOR NEAR EAST POL'Y (May 2, 2014), <http://www.washingtoninstitute.org/policy-analysis/view/the-terrorist-funding-disconnect-with-qatar-and-kuwait>.

⁸ Dahlia Kholaf, *Will the GCC Survivor Qatar-Saudi Rivalry?*, AL-JAZEERA (Mar. 18, 2014), <http://www.aljazeera.com/indepth/features/2014/03/will-gcc-survive-qatar-saudi-rivalry-201431864034267256.html> (arguing that the withdrawal of diplomats from Qatar by Saudi Arabia, the United Arab Emirates and Bahrain could significantly set back relations and proposals for further Gulf Cooperation Council unification).

⁹ See Robert Windrem, *Who's Funding ISIS? Wealthy Gulf 'Angel Investors' Officials Say*, NBC NEWS (Sept. 21, 2014), <http://www.nbcnews.com/storyline/isis-terror/whos-funding-isis-wealthy-gulf-angel-investors-officials-say-n208006>.

¹⁰ Lori Boghardt, *Qatar and ISIS Funding: The U.S. Approach*, THE WASH. INST. FOR NEAR EAST POL'Y (Aug. 2014), <http://www.washingtoninstitute.org/policy-analysis/view/qatar-and-isis-funding-the-u.s.-approach>.

¹¹ See Windrem, *supra* note 9 ("U.S. officials say the Qataris do not strictly enforce their laws").

¹² See *infra* Section 1(B) (explaining the development of Qatar's judicial branch and the effects on the Emir's ability to enforce laws).

¹³ *Id.*

constitutionally limited the ability of the international community to pressure the ruling family to improve the regulation of the domestic financial sector. This article will suggest a limited return of the Emir to the traditional tribal role of arbitrator of justice. Promulgating regulations that increase the Emir's assertiveness over the judicial system will allow the executive branch the constitutional power to better oversee the enforcement and prosecution of the country's counterterrorism financing regime.

Part I of this article will provide an introduction to Qatar before embarking on a brief history of Qatar's legal development to provide a background on the establishment of the modern judiciary. Part II will analyze Qatar's current counterterrorism financing laws, focusing on the 2010 Promulgating Combatting Anti-Laundering and Terrorist Financing Law, and use international standards to conclude these regulations have been soundly drafted. Part II will then establish evidence that the continued permissive financial environment in Qatar is an issue of enforcement rather than poorly drafted laws and establish that the independent nature of the judiciary is the cause of these enforcement shortcomings. Finally, this article will posit a solution of increasing the role of the Emir over certain mechanisms of the judicial system.

I. BACKGROUND

A. *Why Qatar Matters*

Qatar's dazzling modern capital, Doha, is a testament to the remarkable turnaround the nation has experienced over the past twenty years.¹⁴ Qatar is strategically situated at the political center of the Near East and on top of one of the largest natural gas deposits on Earth.¹⁵ Despite this, until a 1994 palace coup brought the current Emir Tamim bin Hamad al-Thani's father, Hamad bin Khalifa al-Thani, into power, Qatar largely squandered this advantage and remained a pre-modern desert society.¹⁶ The glitz of Doha's skyscrapers, which rose almost overnight from the desert sands, stand as a representation of the remarkable transformation Qatar has undergone since the 1994 coup and the impressive influence it now commands.¹⁷ Surprisingly little academic research has been dedicated to

¹⁴ KAMRAVA, *supra* note 3, at 135 ("driving around Doha one is impressed...by what one sees all around-dramatic and often outlandish manifestations of the country's extraordinary physical transformation").

¹⁵ THE WORLD FACT BOOK, *supra* note 1, at 567.

¹⁶ *Id.* at 565.

¹⁷ See KAMRAVA, *supra* note 3, at 135.

Qatar, and some perspective on Qatar's importance in world affairs will help to illustrate the importance of its role in counterterrorism efforts.¹⁸ Background on this will focus on three main factors: 1) Qatar's vast petrochemical wealth; 2) the global influence of Qatar's media giant Al-Jazeera; and 3) Qatar's key international relations. This section will then address Qatar's position as an enduring hub for terrorism financing.

1. *Petroleum Wealth*

Located on a peninsula in the Persian Gulf, Qatar is geographically smaller than the state of Connecticut.¹⁹ Despite this small territorial area Qatar's land and maritime boundaries govern the third-largest proven reserves of natural gas in the world.²⁰ Exploitation of Qatar's petroleum reserves began in the mid-1990s fueling an economic boom previously unimaginable to the traditionally tribal society.²¹ For a period extending until the recent North American shale renaissance, Qatar utilized its position as the number one exporter of natural gas to sustain economic growth averaging over 10% annually.²² Mineral wealth has allowed Qatari citizens to achieve the world's highest per-capita income and no country enjoys a lower unemployment rate.²³

Qatar has also leveraged its petroleum wealth to bolster its position in the world by assertively investing in financial ventures across the globe.²⁴ In Great Britain, the Qatari government's sovereign investment fund now controls many of London's iconic landmarks including Harrods, Hyde Park, and the tallest skyscraper in Europe affectionately known as "The Shard."²⁵ Similar examples can be found across Europe and in emerging economies in Asia and the Middle East, where in places like the Palestinian Territories Qatari strategic investment has come in the form of both business

¹⁸ *Id.* at 4-5 ("Qatar itself remains largely below the scholarly radar, frequently overlooked by observers of the region in favor of its larger or more troubled neighbors").

¹⁹ THE WORLD FACTBOOK, *supra* note 1, at 566.

²⁰ *Id.* at 567.

²¹ *Id.*

²² *Id.*; see also KAMRAVA, *supra* note 3, at 145 (noting that "Qatar's economy grew at 18.8% and 18% percent in 2010 and 2011 respectively").

²³ THE WORLD FACTBOOK, *supra* note 1, at 567.

²⁴ KAMRAVA, *supra* note 3, at 144-45 (stating that the size of Qatar's government owned sovereign wealth fund was estimated at \$85 billion in 2012 with financial "stakes in companies, banks, and various development projects in Asia, North America, and Europe").

²⁵ *Id.*; Edna Fernandes, *How Qatar Bought Britain*, DAILY MAIL, Mar. 10, 2012, <http://www.dailymail.co.uk/news/article-2113159/Qatar-bought-Britain-They-Shard-They-Olympic-Village-And-dont-care-Lamborghini-clamped-shop-Harrods.html>.

acquisition and humanitarian aid.²⁶ Qatar's energy wealth has fueled its international ambitions²⁷ and with petroleum reserves expected to last well into the next century, this influence is almost certain to continue.²⁸

2. *Influence on Al-Jazeera*

The global media giant Al-Jazeera represents another avenue of Qatar's influence.²⁹ "Al-Jazeera was founded in 1996 in Qatar after the Emir...purchased the rights" to an Arab news station the British Broadcasting Corporation had been attempting to start.³⁰ The network quickly proliferated across the region as the first Arab news station to offer a wider latitude of opinions than had customarily been offered through state-controlled media.³¹ Al-Jazeera's goal of objectivity based on the model of news agencies like CNN has made it a globally respected and influential news source.³²

Despite comparative neutrality, Al-Jazeera remains largely funded by the Qatari government and continues to come under scrutiny for its bias in favor of the Emir's regime.³³ A U.S. Congressional Research Service report from 2003 stated that "although the Qatari government has sought to distance itself from Al-Jazeera...both the state and the station enjoy a mutually beneficial relationship. Al-Jazeera, though functionally independent, could be said to indirectly serve the foreign policy goals of Qatar."³⁴ As an example, the ongoing Arab Spring has been drastically shaped and galvanized by Al-Jazeera's coverage.³⁵ Many experts cite the

²⁶ ADAM HANIEH, *CAPITALISM AND CLASS IN THE GULF ARAB STATES* 151, 171 (Palgrave Macmillan, 1st ed. 2011) (stating that "GCC investments vastly exceed those from any other major capital-exporting region to the Mashreq" and defining the Mashreq countries as Jordan, Lebanon, Egypt, Palestine and Syria).

²⁷ See *id.* (arguing that a new type of "khaleeji" capitalism exists represented by the strategic investment of capital from the Persian Gulf into ventures across the global marketplace).

²⁸ John Pratap, *Qatar's Gas Reserves 'Set to Last 156 Years'*, GULF TIMES, Sept. 9, 2014, <http://www.gulf-times.com/qatar/178/details/407519/qatar's-gas-reserves-'set-to-last--156-years'>.

²⁹ KAMRAVA, *supra* note 3, at 9, 13 (noting Qatar's use of Al-Jazeera in foreign policy and as a source of "soft power" on the international stage).

³⁰ JEREMY SHARP, CONG. RES. SERV., *THE AL-JAZEERA NEWS NETWORK: OPPORTUNITY OR CHALLENGE FOR THE U.S. FOREIGN POLICY IN THE MIDDLE EAST?* 1 (2003).

³¹ *Id.* at 2.

³² *Id.*

³³ See KAMRAVA, *supra* note 3, at 75 ("Wikileaks cables show what at times appear to be close coordination between the Qatari government and the television cable").

³⁴ SHARP, *supra* note 30, at 4.

³⁵ See KAMRAVA, *supra* note 3, at *Introduction* (citing as an example that Al-Jazeera provided "a forum for Muslim Brotherhood figures to criticize Egypt").

spread of revolution from Tunisia to Egypt, Libya, and Syria as a direct result of access to the news station and the ideas advocated by it.³⁶

3. *International Diplomacy and Relations*

Qatar's growing influence has also been marked by an increasingly assertive diplomatic presence.³⁷ A 2014 report by the U.S. Congressional Research Service noted that "Qatari officials have positioned themselves as mediators and interlocutors in a number of regional conflicts in recent years."³⁸ A friend to all, the Qatari government has "simultaneously been championed as a Western ally in the fight against terror and criticized as the Middle East's chief enabler of radical jihad."³⁹ Qatar maintains relationships with Hamas and the Taliban, yet considers itself part of the American security umbrella and an indispensable American ally in the region regarding both diplomatic and military efforts.⁴⁰

In 2014 alone, Qatar played an instrumental role in various American operations from strategic planning against the Islamic State in Syria to the release of an American soldier from Taliban capture.⁴¹ Al-Udeid Air Base located just outside of Doha is a major installation for the U.S. Air Force.⁴² The base is one of the largest in the region and hosts the Air Force's regional Combined Air Operations Center, "where officers oversee combat aircraft in Afghanistan and track air traffic across the volatile Middle East."⁴³ Qatar is also a major importer of American weapons.⁴⁴ The Qatari government recently secured an \$11 billion arms deal to purchase, among

³⁶ See *id.* at 77.

³⁷ *Id.* at 7 (noting Qatar's "hyperactive diplomacy...not content remaining in the shadows of regional superpowers").

³⁸ CHRISTOPHER M. BLANCHARD, CONG. RES. SERV., QATAR: BACKGROUND AND U.S. RELATIONS (Jan. 2014).

³⁹ Paul Alster, *Qatar's Terror Funding Makes it More Foe Than Friend to U.S.*, *Critics Say*, FOX NEWS, Sept. 16, 2014, <http://www.foxnews.com/world/2014/09/16/qatar-cozies-up-to-us-while-funding-terror-say-critics/>.

⁴⁰ KAMRAVA, *supra* note 3, at 8.

⁴¹ Elizabeth Dickinson, *The Case Against Qatar*, FOREIGN POLICY, Sept. 30, 2014, http://www.foreignpolicy.com/articles/2014/09/30/the_case_against_qatar_funding_extremists_salafi_syria_uae_jihad_muslim_brotherhood_taliban.

⁴² BLANCHARD, *supra* note 38.

⁴³ Alster, *supra* note 39.

⁴⁴ HANIEH, *supra* note 26, at 77 (noting that as "reflecting the character of their strategic alliances, US and UK weapons producers supplied the overwhelming proportions of weapons to the GCC").

other things, PATRIOT missiles, Apache helicopters, and Javelin anti-tank missiles.⁴⁵

4. *Allegations of Terrorist Organization Financing*

Understanding Qatar's influence across the international stage leads to an appreciation of the importance of Qatar's counterterrorism role and its supporting legal regime. A sustained permissive environment for terrorism related financing activity holds major consequences for the War on Terror. Despite domestic action to regulate the financial sector, U.S. Treasury Undersecretary David Cohen has stated that Qatar remains a "permissive jurisdiction for terrorist financing" with allegations of Qatar's involvement generally focusing on two sources.⁴⁶

Various advocacy groups have alleged that the Qatari government itself, including members of the Emir's family, is funding armed groups with either United Nations ("U.N.") or U.S. government terrorist designation.⁴⁷ These accusations have spurred from Qatar's active role in the Arab Spring supporting varying insurgent groups in Libya and Egypt, Hamas in Gaza, and rebel factions in the Syrian civil war.⁴⁸ The 2013 diplomatic break initiated by Saudi Arabia and the United Arab Emirates came in protest of Qatar's open support of many of these groups.⁴⁹ The Emir has maintained that his government supports only vetted moderate groups and that Qatar does not in any way support terrorist organizations.⁵⁰ The U.S. government officially supports these claims, stating that it "does not have evidence the government of Qatar is funding terrorist groups."⁵¹

⁴⁵ Agence France-Presse, *US: Qatar to Buy Patriot Missiles in \$11B Deal*, GULF NEWS, July 15, 2014, <http://gulfnews.com/news/gulf/qatar/qatar-to-buy-patriot-missiles-in-11b-arms-deal-us-1.1359933>.

⁴⁶ William Mauldin, *U.S. Calls Qatar, Kuwait Lax Over Terror Financing*, WALL STREET J., Oct. 23, 2014, <http://online.wsj.com/articles/u-s-calls-qatar-kuwait-lax-over-terror-financing-1414108799>.

⁴⁷ Alster, *supra* note 39.

⁴⁸ Lina Khatib, *Qatar's Foreign Policy: The Limits of Pragmatism*, 89:2 INT'L AFFAIRS 419, 420-22 (2013) (detailing Qatar's role in the various Arab Spring uprisings, motivated by domestic security and regional leadership considerations).

⁴⁹ Kholaif, *supra* note 8.

⁵⁰ Mick Krever, *Qatar's Emir: We Don't Fund Terrorists*, CNN (Sept. 25, 2014), <http://www.cnn.com/2014/09/25/world/meast/qatar-emir/> (reporting on the Emir's statements regarding Qatar's role in the War on Terror during an interview with CNN following concerns over Qatar's role in aiding the rise of the Islamic State in Iraq and Syria).

⁵¹ Boghardt, *supra* note 10.

Instead the U.S. government has focused on a second group as a major terrorist funding source: private Qatari citizens.⁵² A “steady flow of money to ISIS [and other terrorists] from rich individuals in the Gulf continues, say current and former U.S. officials, with Qataris [being] the biggest suppliers.”⁵³ Though early on the War on Terror focused on Saudi Arabia and the United Arab Emirates, officials now believe the largest share of individual support is coming from Qatari citizens.⁵⁴

Whether the Qatari government is funding terrorist organizations or has remained purposefully compliant in acquiescing to its citizens funding such organizations, it is clear the “Qatari government has done less to stop the flow than its neighbors in Saudi Arabia and the United Arab Emirates.”⁵⁵

B. Legal Development

Understanding that Qatar has been less effective at regulating its financial sector than other nations identified by the international community, this article will focus on a legal approach to investigate why. By delving into a history of the development of Qatar’s legal system the answer to why Qatar’s counterterrorism financing regime has fallen short becomes clear in the independent nature of the courts. Qatar’s development has created a system in which the state’s judicial complex “is a rather independent body with a well-defined structure...not subordinate to the Emir and his ministers.”⁵⁶ This phenomenon is unique in a region, where despite claims of independence, legal systems are functionally “regulated by special committees or courts which are supervised by the King.”⁵⁷ Qatar’s legal history not only helps explain why its counterterrorism financing laws have been ineffective, but also sheds light on the best solution to make the laws effective.

1. Pre-Colonial Period

Qatar’s legal history dates back over a thousand years before the modern nation state came into existence.⁵⁸ Until the eighteenth century

⁵² *Id.*

⁵³ Windrem, *supra* note 9.

⁵⁴ *Id.*

⁵⁵ *Id.*

⁵⁶ Nizar Hamzeh, *Qatar: The Duality of the Legal System*, 30 MIDDLE EAST STUDIES 79 (1994).

⁵⁷ *Id.*

⁵⁸ *Id.* at 80.

Qatar's population largely consisted of nomadic tribes who used the peninsula as a rangeland.⁵⁹ Few permanent settlements existed outside of towns located on the peninsula's coast, the largest of which was located in the area of modern Doha.⁶⁰ Middle East analyst Helen Chapin Metz notes in her country study on Qatar for the U.S. Library of Congress that "the Qatari peninsula came under way of several great powers over the centuries" including the Abbasid dynasty, Portugal, and the Ottoman Empire, however little change to the tribal way of life is recorded.⁶¹

The customs of tribal society dominated the early development of law in the peninsula.⁶² Legal scholar A. Nizar Hamzeh explains that "Qatari tribes settled their disputes according to the customs of desert law recognizing Islam as an article of faith" following its introduction to the region in the seventh century.⁶³ This system worked under the guiding power of the tribe's sheikh, the protector and center of power in the tribe.⁶⁴ The sheikh of each Qatari tribe operated "simultaneously as a political chief and the supreme judge of tribal disputes."⁶⁵ As an arbitrator the sheikh enforced justice in the tribe using a "strict enforcement of desert rules and customs."⁶⁶

As the centuries passed, desert tribal law began to dissolve into a system increasingly dominated by the Islamic sharia.⁶⁷ Unlike its modern variances, traditional sharia is a personal Islamic religious system meaning "the way to follow" God as revealed to the Prophet Muhammad.⁶⁸ Hamzeh explains that Muslims believe sharia is "a one-way legal system from God to the individual ... [that] does not differentiate between civil obligations

⁵⁹ *Id.* (explaining Qatar was divided into two groups of persons: the *badu* who were nomads who "roamed the inlands in search of food" and the *hadar* who settled along the peninsula's coast); see also LIBRARY OF CONGRESS, PERSIAN GULF STATES: A COUNTRY STUDY 154 (Helen Chapin Metz ed., 1993) [hereinafter PERSIAN GULF STATES: A COUNTRY STUDY].

⁶⁰ *Id.*

⁶¹ PERSIAN GULF STATES: A COUNTRY STUDY, *supra* note 59.

⁶² Hamzeh, *supra* note 56, at 80 (noting "scholars are almost unanimous in their opinion that custom is not only the oldest source of law, but also an important one that has shaped the different legal systems in traditional societies").

⁶³ *Id.*

⁶⁴ *Id.*

⁶⁵ *Id.* (explaining the sheikhs traditional role included sole authority to arbitrate "matters such as the amount and form of dowry payments, use of wells, homicide, theft, adultery and rape").

⁶⁶ *Id.*

⁶⁷ *Id.*

⁶⁸ *Id.*

and religious ones.”⁶⁹ Under sharia systems civil authorities have the power to regulate society but must adhere to religious principles.⁷⁰ By the end of the eighteenth century, sharia had changed many aspects of the tribal system in Qatar; however, many desert customs were integrated into sharia jurisprudence and survived.⁷¹

One interpretation of sharia that gained prevalence at this time was known as the Wahhabi movement, a school of belief descending from the Islamic Hanabali School of legal tradition.⁷² The Wahhabi movement advocated for what Hamzeh explains as a strict return to adherence “to [only] the Qur’an and Sunna (traditions of the Prophet) as the major sources of sharia”⁷³ and rejected individual interpretation from scholarly jurisprudence as an acceptable source for law.⁷⁴ The modern ruling family of Qatar, the al-Thanis, “adherents of Wahhabism, used the movement to legitimize” power in Qatar and subsequently “brought Qatar under sharia law as it was interpreted under Wahhabism.”⁷⁵ Under this system, Hamzeh notes that full jurisdiction over civil and criminal proceedings was transferred to sharia judges; however individuals retained “the right to appeal their cases to the Emir of the ruling family, who had full judicial power as a court of appeal. Thus, little separation continued to exist between the judicial power and the executive power of the Emir.”⁷⁶

2. *Qatar under British Rule*

Under increasing threat of Ottoman intervention, Qatar entered into a treaty for protection with the British Empire in 1916.⁷⁷ Britain took an increasing interest in Qatar following the discovery of petroleum resources

⁶⁹ *Id.* at 81; see also REZA ASLAN, NO GOD BUT GOD: THE ORIGINS, EVOLUTION AND FUTURE OF ISLAM 164 (Random House Trade Paperbacks, 2nd ed. 2011) (“the Sharia is divided into two categories: regulations regarding religious duties, including the proper method of worship, and regulations of a purely juridical nature”).

⁷⁰ Hamzeh, *supra* note 56, at 81.

⁷¹ *Id.*

⁷² *Id.*

⁷³ *Id.*

⁷⁴ ASLAN, *supra* note 69, at 246 (explaining that for a Wahhabi “God must be the sole object of religious devotion; any act of worship that involved any other entity whatsoever is considered shirk” or a sinful act in Islam associating anything with God).

⁷⁵ Hamzeh, *supra* note 56, at 81.

⁷⁶ *Id.*

⁷⁷ PERSIAN GULF STATES: A COUNTRY STUDY, *supra* note 59, at 158 (observing that as a British protectorate, Qatar retained limited domestic autonomy but “relinquished its autonomy in foreign affairs and other areas such as the power to cede territory”).

in 1939.⁷⁸ Interaction between Westerners and Qataris increased substantially during this period with a large population of British nationals living in Qatar for business and government purposes.⁷⁹

The presence of British nationals in Qatar brought with it British legal institutions.⁸⁰ The British Parliament in London passed the British Foreign Acts legislation, which gave all British law “extraterritorial validity in the principalities of the Gulf.”⁸¹ In Qatar, rather than replacing the sharia system with Western law, the British legal institutions operated parallel alongside the sharia courts.⁸² British citizens were subjected to the jurisdiction of the British courts located in the British embassy and were completely independent from Qatari sharia institutions, which continued to adjudicate over Muslim Qataris.⁸³ This dual legal system thrived throughout British rule.⁸⁴

3. *Post Independence Development*

Great Britain announced its disengagement from the region in the late 1960’s leading to Qatar’s peaceful independence in 1971.⁸⁵ An immediate problem arose for the new government concerning the question of legal jurisdiction over the considerable population of non-Muslims remaining in the country as expatriate workers.⁸⁶ While the sharia courts continued to hold influence over Muslim nationals, the remaining non-Muslim expatriates previously under the jurisdiction of the now vacated British courts and laws provided a legal dilemma.⁸⁷ In addition, Hamzeh observes “new laws and new techniques were urgently required to deal with the consequences and problems of modernization that were unknown not only to sharia law but to the sharia court as well.”⁸⁸

⁷⁸ *Id.* at 159.

⁷⁹ Hamzeh, *supra* note 56, at 82.

⁸⁰ *Id.*

⁸¹ *Id.*

⁸² *Id.*

⁸³ *Id.*

⁸⁴ *Id.*

⁸⁵ PERSIAN GULF STATES: A COUNTRY STUDY, *supra* note 59, at 161-62 (citing that for economic reasons “in 1968 Britain announced its intention of withdrawing military commitments east of the Suez Canal” including the Persian Gulf).

⁸⁶ Hamzeh, *supra* note 56, at 82.

⁸⁷ *Id.*

⁸⁸ *Id.* (Emir Khalifa bin Hamad al-Thani promulgated Qatar’s Permanent Constitution on April 2, 1970 which was then superseded by an amended Permanent Constitution on April 19, 1972. This version of the Permanent Constitution served as Qatar’s constitution until the adoption of a new constitution in 2004 by Emir Hamad bin Khalifa al-Thani).

The ruling family's solution was drafted into the Permanent Constitution of Qatar ("Permanent Constitution") and "the Constitutional Provisional Amended Basic Statute that defined the system of rule in the state."⁸⁹ Hamzeh explains that "the [Permanent] Constitution marked the beginning of an attempt to organize the judiciary. This organization ... resulted in a division of Qatar's judicial system: while the sharia court applied sharia law, [a separate] *Adlia* court" enforced domestic statutes in a Western-influenced civil law system.⁹⁰ In practice the sharia courts were intended to remain the jurisdictional choice of Muslims while non-Muslims would be free to bring claims in the *Adlia* court system.⁹¹ As a result Qatar's Permanent Constitution sustained and codified a dual legal system unlike any other in the Persian Gulf.⁹²

The Permanent Constitution also contained several provisions outlining the desire for all judicial processes to remain independent from the executive.⁹³ The Judges Articles of the Permanent Constitution "stated that 'Judges shall be independent in the exercise of their power and that there shall be no interference in the administration of justice by anyone.'"⁹⁴ While the Emir and his ministers retained informal control over the sharia system,⁹⁵ the Permanent Constitution codified the independence the former British courts had enjoyed and adopted the aspiration that all courts should function truly independently of the executive branch.⁹⁶ Even though Article 63 established that "court judgments shall be pronounced in the name of the Emir,"⁹⁷ the adoption of the *Adlia* courts "established and refined...the concept of a judiciary, separate and independent from the religious authority and the person of Emir as ruler."⁹⁸

In the years that followed, Qatar's dual system continued to develop in a unique way. Despite intent that the *Adlia* courts maintain jurisdiction over mainly foreign expatriates, the courts began to be increasingly utilized by

⁸⁹ Ahmed Kehdr, *A Guide to Qatar's Legal System*, GLOBALEX (July 2009), <http://www.nyulawglobal.org/globalex/Qatar.htm#QatarLegalsystem>.

⁹⁰ Hamzeh, *supra* note 56, at 82.

⁹¹ *Id.*

⁹² *Id.* at 79.

⁹³ *Id.* at 83.

⁹⁴ *Id.*

⁹⁵ *Id.* at 79.

⁹⁶ See Kehdr, *supra* note 89.

⁹⁷ *Id.*

⁹⁸ MARCI HOFFMAN, FOREIGN LAW GUIDE: QATAR-LEGISLATION AND JUDICIAL SYSTEM (2016), http://referenceworks.brillonline.com/mutex.gmu.edu/entries/foreign-law-guide/qatar-legislation-and-the-judicial-system-COM_158301#.

Muslim Qataris.⁹⁹ While the sharia courts continued to “[be] charged with adjudication of all matters of personal relationships and civil status according to Islamic law,” the *Adlia* courts grew to dominate civil and criminal matters for all Qataris regardless of creed.¹⁰⁰ Hamzeh describes that “the increasing numbers of civil, criminal, and laws...under the jurisdiction of the *Adlia* court ... gradually contributed to the eclipse of the sharia court” and with it, the influence of the executive branch over the judiciary.¹⁰¹

Following a palace coup against the long-ruling Emir Khalifa bin Hamad al-Thani in 1994, the Emir’s son Hamad bin Khalifa al-Thani assumed power sweeping in an agenda of modernization and reform for Qatar.¹⁰² The Emir decreed that a new constitution (“Amended Constitution”) should be drafted, and following a three-year period, voters approved the new constitution on April 29, 2004.¹⁰³ The Amended Constitution, which governs to this day, built upon the Permanent Constitution and solidified the ruling al-Thani family’s control over the government.¹⁰⁴

The Amended Constitution also made significant changes to the judiciary, including a reorganization of the courts by litigation and appellate stages consisting of varying civil and sharia courts.¹⁰⁵ Despite implementing considerable reform, the drafters of the Amended Constitution chose to expand upon the established independent nature of Qatar’s judiciary.¹⁰⁶ Legal scholar Ahmed Kehdr notes that the

⁹⁹ Hamzeh, *supra* note 56, at 89 (“A review of statistical reports published by the Presidium of the sharia Courts indicates that while there has been an increase in cases related to family law and Muslim personal status, there has been a decrease on the other hand in cases related to crimes and felonies. The reports show that cases of personal status such as marriage, divorce, inheritance and property rights have increased from 60 per cent in 1984 to 85 per cent in 1988, while the cases of homicide and felonies have dropped from 40 per cent in 1984 to 15 per cent in 1988.”).

¹⁰⁰ Hoffman, *supra* note 98.

¹⁰¹ See Hamzeh, *supra* note 56, at 86 (arguing that the role of the sharia courts in Qatar has largely been limited to matters relating to family law).

¹⁰² THE WORLD FACTBOOK, *supra* note 1, at 592.

¹⁰³ Kehdr, *supra* note 89. Emir Hamad bin Khalifa al-Thani issued Decree Number 11 in 1999 to establish a committee to draft a new constitution. The Emir highlighted the goals of the new constitution to ensure “the establishment of a modern state, by enhancing the role of Shari’a, democracy and the popular participation of the citizen in decision making.” Following the conclusion of drafting a largely ceremonially public referendum vote was held with Qatari voters approving the Amended Constitution on April 29, 2004. *See id.*

¹⁰⁴ *See id.*

¹⁰⁵ See Hoffman, *supra* note 98.

¹⁰⁶ See PERMANENT CONSTITUTION OF THE STATE OF QATAR, Aug. 6, 2004, arts. 63, 129-3; *see also* Kehdr, *supra* note 89.

continuation of the Permanent Constitution's provisions regarding the importance of independent judicial proceedings in the Amended Constitution stands as a testament to the extent Qatar's legal culture has developed to formally recognize "that the independence of the judiciary is inviolable and is protected by law against interference from other authorities."¹⁰⁷ The Amended Constitution dedicates three articles to declaring judicial autonomy:

Article 129

The supremacy of law is the base of rule in the State. The honour of the judiciary, its integrity, and impartiality of judges are a safeguard of rights and liberties.¹⁰⁸

Article 130

The judicial authority shall be independent and it shall be vested in courts of different types and grades. The courts shall make their judgments according to the law.¹⁰⁹

Article 131

Judges are independent and they shall not be subject to any power in the exercise of their judicial functions as provided by the law and no interference whatsoever shall be permitted with court proceedings and the course of justice.¹¹⁰

In many of the Persian Gulf monarchies surrounding Qatar, constitutions facially declare the courts to be independent from executive influence.¹¹¹ Qatar is unique in the extent to which this independence appears to be developed and adhered to in practice.¹¹² In Saudi Arabia, though the courts are functionally independent, the King continues to derive the power to control the judiciary based on a duty to implement sharia law.¹¹³ In Qatar however, the legitimization and subsequent jurisdictional dominance of the non-sharia courts, which historically were independent

¹⁰⁷ See Kehdr, *supra* note 89.

¹⁰⁸ PERMANENT CONSTITUTION, *supra* note 106, at art. 129.

¹⁰⁹ *Id.* at art. 130.

¹¹⁰ *Id.* at art. 131.

¹¹¹ See, e.g., Abdullah Ansary, *A Brief Overview of the Saudi Arabian Legal System*, GLOBALEX (July 2008),

http://www.nyulawglobal.org/globalex/Saudi_Arabia.htm#_Toc200894565.

¹¹² See Hamzeh, *supra* note 56 ("In contrast to the prerogatives of the ministers of justice of Saudi Arabia, Bahrain, Kuwait and UAE, Qatar's minister of justice may supervise but does not legislate secular laws").

¹¹³ Ansary, *supra* note 111.

from the Emir's influence, has helped establish a legal culture of a judiciary independent from executive control.¹¹⁴ In effect, the relegation of the sharia courts in modern Qatar has functionally limited the Emir's ability to administer the judicial complex and ensure laws are properly enforced.¹¹⁵ This system is unique in the Arab world and is crucial to recognize before departing into an analysis of Qatar's counterterrorism financing regime.

II. ANALYSIS

The problems existing in Qatar's financial regime bring forth several issues to analyze. First, this article will assess the competence of the current anti-funding laws and regulatory mechanisms in force in Qatar. This investigation will demonstrate that while the drafting of Qatar's laws meet international standards, enforcement has been lacking. The question becomes why enforcement issues continue to exist despite international pressure on the Qatari government to improve regulation of the financial sector. From an understanding of its judicial development, this article will posit that Qatar's thriving judicial system, independent from the direct control of the Emir, has led to a lax enforcement environment. This article will return to Qatar's legal traditions to posit the best solution to overcome this problem.

A. *Current Counterterrorism Financing Legal Regime*

Qatar's financial sector is shaped and regulated by several international, regional, and domestic counterterrorism bodies.¹¹⁶ The U.S. State Department has stated that "the government of Qatar routinely engages with international interlocutors on terrorist financing. Qatar is a member of the Middle East North Africa Financial Action Task Force (MENAFATF),"¹¹⁷ a regional body similar to the intergovernmental Financial Action Task Force (FATF), which is an international policy-making organization whose recommendations are recognized as the international standard for money laundering and terrorist financing regulations.¹¹⁸ MENAFATF comprises fourteen countries and was formed

¹¹⁴ See Hamzeh, *supra* note 56, at 89.

¹¹⁵ *Id.*

¹¹⁶ *Country Reports on Terrorism 2013-Qatar*, *supra* note 6.

¹¹⁷ *Id.*

¹¹⁸ *Id.*; see also *Who we are*, FINANCIAL ACTION TASK FORCE, <http://www.fatf-gafi.org/about/whoweare/> (last visited Mar. 26, 2016) ("The objectives of the FATF are to set standards and promote effective implementation of legal, regulatory and operational measures for combating money laundering, terrorist financing and other related threats to the integrity of the international financial system.").

in 2004 to cooperate with FATF and uphold international guidelines including treaties, U.N. conventions, and U.N. Security Council resolutions regarding money laundering and terrorist financing activity.¹¹⁹ In addition, Qatar maintains a domestic National Antiterrorism Committee (NATC) that oversees the state's efforts to combat terrorism.¹²⁰ NATC's functions include "formulating Qatar's counterterrorism policy, fulfilling Qatar's obligations to combat terrorism under international conventions, and participating in international U.N. conferences on terrorism."¹²¹

These institutions are supported by Qatar's counterterrorism financing laws, which consist of an extensive regulatory regime criminalizing terrorism financing and related money laundering activities.¹²² The Promulgating Combatting Money Laundering and Terrorism Financing Law of 2010 (CMLTF Law) and a recently-passed law regulating private donations to charities represent the cornerstones of Qatar's domestic laws and implementation of international obligations.¹²³

1. *Combatting Money Laundering and Terrorism Financing Law*

The Emir decreed Qatar's CMLTF Law in 2010 as a comprehensive update of regulation on terrorist financing.¹²⁴ The CMLTF Law amended a wide range of domestic statutes including the Combatting Terrorism Law of 2004 and Qatar's statutory Penal Code and Code of Criminal Procedure.¹²⁵ While the 2004 Combatting Terrorism Law "set forth broad provisions for defining and prosecuting terrorist related activities in Qatar," the CMLTF Law specifically focused regulation on financial activity.¹²⁶

Analysis of the CMLTF Law's provisions reveals extensive inclusion of recommendations by various international organizations. As a member of the U.N. and party to the U.N. International Convention for the Suppression of the Financing of Terrorism ("ICSFT"), Qatar is obligated to uphold certain international standards regarding money laundering and

¹¹⁹ *About MENAFATF*, MENAFATF

<http://www.menafatf.org/topiclist.asp?ctype=about&id=546> (last visited Mar. 26, 2016).

¹²⁰ *Country Reports on Terrorism 2013-Qatar*, *supra*, note 6.

¹²¹ *Id.*

¹²² *See* Law No. 4 of 2010 On Combatting Money Laundering and Terrorist Financing [Law No. 4] (Qatar) [hereinafter Law No. 4].

¹²³ *See id.* & *see infra* notes 145-155 and accompanying text.

¹²⁴ *See* Law No. 4, *supra* note 122.

¹²⁵ *Id.*

¹²⁶ *Country Reports on Terrorism 2013-Qatar*, *supra* note 6.

terrorist financing.¹²⁷ Upon close examination, it is evident that governing language required by U.N. Security Council Resolution 1373 (“U.N. Resolution 1373”)¹²⁸ and the ICSFT is adopted throughout the CMLTF Law.¹²⁹

ICSFT Article 4 establishes that state parties should pass domestic laws criminalizing terrorist financing offences and appropriately penalizing such activities.¹³⁰ U.N. Resolution 1373§1(b) similarly requires that U.N. member states “criminalize the willful provision or collection, by any means, directly or indirectly, of funds...with the intention...that the funds should be used in order to carry out terrorist acts.”¹³¹ The drafting of Qatar’s CMLTF Law appears to satisfy these requirements. The CMLTF Law’s Article 4 strongly implements U.N. Resolution 1373§1(b), declaring:

“It is prohibited to participate through association, aiding, abetting, facilitating, counseling in, cooperation, contribution or conspiracy, to commit, attempt to commit any of the forms of the terrorism financing crime.”¹³²

The CMLTF Law’s provisions additionally regulate multiple transaction points by placing legal obligations on both private individuals and financial institutions.¹³³ The CMLTF Law’s Article 5 focuses on private individuals, establishing that any person with knowledge of terrorist financing crimes who does not inform competent authorities will be found legally culpable.¹³⁴ Article 3 places requirements on financial institutions to monitor information on legal persons, organizations, and transactions and forbids any relationships with shell banks.¹³⁵

U.N. Resolution 1373§3 calls on states to “find ways of intensifying and accelerating the exchange of operational information” related to counterterrorism efforts.¹³⁶ Pursuant to this, Qatar’s CMLTF Law contains

¹²⁷ See S.C. Res. 1373 (Sept. 28, 2001); G.A. Res. 54/109, U.N. International Convention for the Suppression of Financing of Terrorism (Dec. 9, 1999) [hereinafter ICSFT]. Qatar became a permanent member of the U.N. in 1971 and announced accession to the U.N. International Convention for the Suppression of the Financing of Terrorism on July 27, 2008.

¹²⁸ See generally S.C. Res. 1373, *supra* note 127.

¹²⁹ See generally ICSFT, *supra* note 127.

¹³⁰ ICSFT, *supra* note 127, at art. 4.

¹³¹ S.C. Res. 1373, *supra* note 127, at § 1(b).

¹³² Law No. 4, *supra* note 122.

¹³³ *Id.* at arts. 3, 5.

¹³⁴ *Id.* at art. 5.

¹³⁵ *Id.* at art. 3; see also *id.* at art. 1 (defining shell banks as “a bank that has no physical presence in the country or territory in which it has been incorporated and licensed and is not affiliated to any financial services group which is subject to effective and unified regulation”).

¹³⁶ S.C. Res. 1373, *supra* note 127, at § 3(a).

several provisions establishing various committees and units to facilitate information sharing.¹³⁷ CMLTF Article 10 requires the formation of The National Anti-Money Laundering and Terrorism Financing Committee at Qatar Central Bank to coordinate anti-terrorist financing strategy.¹³⁸ The CMLTF Law's Chapter 5 further establishes an independent Financial Information Unit (FIU) to monitor suspected terrorist financing acts.¹³⁹ FIU is required to report all cases to the Office of the Public Prosecutor, which is charged with criminal prosecutions under the law.¹⁴⁰

The CMLTF Law also complies with international recommendations to set forth strict penalties for terrorist financing convictions. U.N. Resolution 1373§2(e) requires that states ensure "terrorist acts are established as serious criminal offences in domestic laws and regulations and that the punishment duly reflects the seriousness of such acts."¹⁴¹ Pursuant to this Resolution, the CMLTF Law's Article 72 sets criminal punishment for convictions under the law as fines up to two million riyals and imprisonment up to ten years.¹⁴² Both ICSFT and U.N. Resolution 1373§1(c) also require the freezing of financial assets or economic resources of those involved in terrorist financing.¹⁴³ The CMLTF Law's Article 50 authorizes¹⁴⁴ the "Public Prosecutor to freeze the funds of terrorist organizations designated by the U.N." and the funds of individuals who finance them.¹⁴⁵

In summary, analysis of the language of Qatar's CMLTF Law does not bring to light major deficiencies. The provisions of the law appear to be legally sound and in compliance with international standards. In many cases throughout, the law's language and regulations appear to exceed the provisions set forth in the leading governing international regimes.

¹³⁷ See Law No. 4, *supra* note 122.

¹³⁸ See *id.* at art. 10.

¹³⁹ *Id.* at art. 14 ("The Unit shall serve as a central national body which shall be responsible for receiving, requesting, analyzing and disseminating information concerning suspected proceeds of crime, potential money laundering or potential terrorism financing operations, as provided for by this law.")

¹⁴⁰ *Id.* at art. 20.

¹⁴¹ S.C. Res. 1373, *supra* note 127 ¶ 2(e).

¹⁴² Law No. 4, *supra* note 122.

¹⁴³ ICSFT, *supra* note 127; S.C. Res. 1373 *supra* note 127, ¶ 1(c).

¹⁴⁴ Law No. 4, *supra* note 122.

¹⁴⁵ *Country Reports on Terrorism 2013-Qatar, supra* note 6.

2. *Private Charity Laws*

The War on Terror has also focused attention on domestic laws overseeing contributions to charities. Following September 11, 2001, the War on Terror brought to light the extensive use of charities as an inventive channel for terrorist funding utilized by private individuals.¹⁴⁶ Charities, even in Western Europe and North America, were largely under-regulated institutions that allowed for individuals to donate large sums to charities abroad acting as shell organizations for terrorist groups.¹⁴⁷ In the Arab world especially, the traditional system of transferring money via a *hawala* broker made the use of shell charities a lucrative option for terrorist organizations.¹⁴⁸

Qatar has been under international pressure to regulate the flow of money into charities for considerable time.¹⁴⁹ The government announced “in 2013 ... [that] a law on charities oversight based on FATF standards was in development.”¹⁵⁰ On September 16, 2014, the Emir announced the new law involving directives to both charities and Qatar’s Central Bank.¹⁵¹ While the details of this new law have yet to be revealed, the law has been categorized as “an extra layer of due diligence to make it clear that charities are not outside of the remit of [existing legislation].”¹⁵² The new regulations are purported to require special permission “before funds are sent outside the country, with charities required to provide receipts and other details of such transactions to authorities.”¹⁵³ As the law currently stands, Qatar’s Ministry of Labor and Social Affairs requires that “foreign partners submit to a vetting and licensing process to provide receipts and other details of such transactions to authorities.”¹⁵⁴ In essence, the new

¹⁴⁶ See Jennifer Bell, *Terrorist Abuse of Nonprofits and Charities: A Proactive Approach to Preventing Terrorist Financing*, 17 KAN. J.L. PUB. POL’Y 450, 451 (2007).

¹⁴⁷ See generally *id.* at 456.

¹⁴⁸ See Rachana Pathak, *The Obstacles to Regulating the Hawala: A Cultural Norm or a Terrorist Hotbed?*, 27 FORDHAM INT’L L.J. 2007 & 2010 (2004) (describing the *hawala* system as a wide spread system used to transfer money, often among diaspora communities, that is often misused to “launder money, evade taxes, traffic contraband, and fund terrorist activity”).

¹⁴⁹ Peter Kovessy, *Qatar clamps down on charities that send funds abroad*, DOHA NEWS, Sept. 20, 2014, <http://dohanews.co/qatar-clamps-charities-send-funds-abroad/> (noting statements from German and U.S. officials scrutinizing regulation on charities in Qatar).

¹⁵⁰ *Country Reports on Terrorism 2013-Qatar*, *supra* note 6.

¹⁵¹ Kovessy, *supra* note 149; see *Stricter Rules to Regulate Charities*, THE PENINSULA, Sept. 14, 2014, <http://thepeninsulaqatar.com/news/qatar/300295/stricter-rules-to-regulate-charities>.

¹⁵² *Id.*

¹⁵³ *Id.*

¹⁵⁴ *Country Reports on Terrorism 2013-Qatar*, *supra* note 6.

charities law will likely ensure that charities fall under the fold of the existing criminal regulations found in the CMLTF Law.¹⁵⁵

B. Evidence of Enforcement Issues

Qatar's financial regulations consist of properly drafted laws supported by an organized counterterrorism bureaucracy in alignment with international guidelines. Despite this, the international community remains concerned that aspects of the Qatari government and its citizens continue to finance radical groups from the mountains of Libya to the deserts of Syria.¹⁵⁶ A 2014 Washington Institute policy analysis by Lori Boghardt observes that while "countering the illicit aspects of private Gulf contributions to foreign organizations certainly poses logistical challenges, these challenges do not account for the protracted implementation process" of the CMLTF Law and excuse the continued flow of money from Qatar.¹⁵⁷ With the proper legal regime in place, Qatar's continuing permissive environment must be viewed as a result of improper enforcement of its laws.¹⁵⁸

The U.S. government has previously highlighted enforcement as a central factor for Qatar's lax terrorist financing environment.¹⁵⁹ While most "Arab states have laws prohibiting such fundraising, U.S. officials say the Qataris do not strictly enforce their laws."¹⁶⁰ Boghardt concludes that "continued financial sanctions imposed on ... Qatari terrorist financiers by the U.S. Treasury 'suggest the U.S. government continues to be concerned about spotty ... Qatari enforcement of their counterterrorism financing laws.'"¹⁶¹ Herbert Morais adds that the lack of enforcement by Qatar's government has resulted in "the lack of effective legal systems that impose strict rules of transparency, accounting, and auditing systems, including periodic statutory reporting on the actual use of funds."¹⁶²

¹⁵⁵ See Kovessy, *supra* note 149.

¹⁵⁶ Windrem, *supra* note 9.

¹⁵⁷ Boghardt, *supra* note 7.

¹⁵⁸ See *id.*

¹⁵⁹ *Id.*

¹⁶⁰ Windrem, *supra* note 9.

¹⁶¹ Janine di Giovanni, et al., *How Does ISIS Fund Its Reign of Terror?*, NEWSWEEK, Nov. 6, 2014, <http://www.newsweek.com/2014/11/14/how-does-isis-fund-its-reign-terror-282607.html>.

¹⁶² Herbert Morais, *Fighting International Crime and Its Finance: The Importance of Following a Coherent Global Strategy Based on the Rule of Law*, 50 VILL. L. REV. 583, 612 (2005).

The enforcement problem appears to be rampant across the monitoring, prosecutorial, and sentencing aspects of Qatar's judicial and executive apparatus.¹⁶³ The U.S. State Department noted in its 2013 Country Reports on Terrorism:

Qatar's lack of outreach and enforcement activities to ensure terrorist-related transactions are not occurring and the lack of referrals by the FIU of cases are significant gaps. No [terrorist] designations were made in 2013. The FIU referred one suspicious transaction report case to the Public Prosecutor for investigation as of November 2013, with no judgment issued as of the year's end.¹⁶⁴

A highly-profiled incident in 2014 concerning Abdulaziz al-Attayah, the cousin of Qatar's former Foreign Minister Khalid bin Mohammed al-Attayah, provides a revealing case study.¹⁶⁵ Abdulaziz al-Attayah was detained in Lebanon in 2014 where he was "convicted of funding international terrorism" after allegedly traveling to the country to secure the transfer of funds to rebel groups in Syria.¹⁶⁶ Following intense pressure from Qatar, al-Attayah was allowed to leave Lebanon and despite his conviction in Lebanese courts has not been further investigated, prosecuted or sentenced under Qatar's CMLTF Law.¹⁶⁷ Incredibly, despite the clear language in its laws the Qatari government has taken no further action to impose penalties on al-Attayah.¹⁶⁸

The U.S. State Department has additionally stated that "despite a strong legal framework, judicial enforcement and effective implementation of Qatar's" anti-financing law are lacking.¹⁶⁹ The 2013 Country Report on Terrorism on Qatar goes on to "describe Doha's monitoring of local contributions to foreign organizations as 'inconsistent.'"¹⁷⁰ Other international institutions including FATF have voiced similar concerns:¹⁷¹

According to FATF, [Qatar's] laws and regulations meet or exceed international counterterrorist financing and anti-money

¹⁶³ *Country Reports on Terrorism 2013-Qatar*, *supra* note 6.

¹⁶⁴ *Id.*

¹⁶⁵ Andrew Gilligan, *Minister's Family Ties to Terror*, TELEGRAPH, Nov. 1, 2014, <http://www.telegraph.co.uk/news/worldnews/middleeast/qatar/11203140/Ministers-family-ties-to-terror.html>.

¹⁶⁶ *Id.*

¹⁶⁷ *See id.*

¹⁶⁸ *Id.*

¹⁶⁹ Boghardt, *supra* note 7.

¹⁷⁰ *Id.*

¹⁷¹ Waszak, *supra* note 4, at 692-93.

laundering standards as written legislation. However, having effective legislation is only the first part of the process. While there might be laws on the books designed to confront terrorist financing, the disparity is in the enforcement of those laws.¹⁷²

Evidence whether enforcement issues will arise regarding Qatar's new law regulating charities has not yet been gathered. If enforcement issues are structural, as this article posits, similar enforcement shortcomings should be expected as a result of the charities law's dependence on prosecution under the CMLTF Law framework.¹⁷³

C. *Legal Development as the Root Cause of Enforcement Issues*

Writing on banking in Arab countries, Bashara Malkawi concluded that "well written laws that criminalize terrorism financing and money laundering are steps in the right direction, but without clarification and implementation, such laws are meaningless."¹⁷⁴ The important question becomes why the Qatari government's implementation and enforcement of its legal regime remains an issue and how to solve this crisis.

In the aftermath of September 11, 2001 countries across the Gulf were criticized for financial environments permissive of money laundering and terrorist activity.¹⁷⁵ At the time Saudi Arabia and the United Arab Emirates, not Qatar, garnered the most scrutiny from the international community.¹⁷⁶ In 2003 the U.S. Treasury Department referred to Saudi Arabia as the "epicenter" of terrorist financing and similarly regarded the United Arab Emirates as "a financial center of the Persian Gulf with lax banking regulations."¹⁷⁷ Similar to Qatar, the problem in these Arab countries was identified as improper enforcement of existing anti-funding laws.¹⁷⁸ A Council on Foreign Relations report on Saudi Arabia stated that "Saudi Arabia had failed to implement or enforce its laws, particularly ... [failing]

¹⁷² *Id.*

¹⁷³ See Kovessy, *supra* note 149.

¹⁷⁴ Bashara Malkawi, *Bank Secrecy in Arab Countries: A Comparative Study*, 123 BANKING L.J. 894, 899 (2006).

¹⁷⁵ *Id.*

¹⁷⁶ Waszak, *supra* note 4, at 676.

¹⁷⁷ *Id.*

¹⁷⁸ *Id.* at 692.

to take public punitive actions on those who are ‘convicted’ for terrorist financing.”¹⁷⁹

In the years since, international action in the form of sanctions and diplomatic pressure in the War on Terror has led to improved judicial and executive enforcement in both Saudi Arabia and the United Arab Emirates.¹⁸⁰ “U.S. officials [have] lauded the cooperation from ... Saudi Arabia and the United Arab Emirates in efforts to stop donations.”¹⁸¹ U.S. Treasury Undersecretary David S. Cohen has stated that considerable success has been met “in tamping down Gulf based donors ... [by] working with partners such as Saudi Arabia and the United Arab Emirates ... to take serious the threat of terrorism.”¹⁸² These governments have increased judicial enforcement of anti-funding laws resulting in the improved security of the international financial system. According to Boghardt, Saudi Arabia’s regime has taken “important measures to discourage terrorist financing abroad”¹⁸³ while the United Arab Emirates is now “one of the most proactive in taking steps to reduce the risk” of financing activity.¹⁸⁴ The evidence is clear that efforts spearheaded by the international community during the War on Terror have been successful in improving legal enforcement in many Gulf countries.¹⁸⁵ Why have such efforts been ineffective in Qatar?

This article posits that Qatar remains an outlier in this trend due to the unique development of its judiciary, which has stripped the Emir of the constitutional authority to ensure crimes under the CMLTF Law’s framework are properly prosecuted. From its dual court system and the modern relegation of sharia, Qatar has developed a judicial system that Nizar Hamzeh describes as “not subordinate to the Emir and his ministers.”¹⁸⁶ The degree of this independence is a defining characteristic that has not developed in many neighboring Arab countries.¹⁸⁷

¹⁷⁹ *Id.*

¹⁸⁰ Cohen, *supra* note 5, at 46-47.

¹⁸¹ Mauldin, *supra* note 46.

¹⁸² Cohen, *supra* note 5, at 46-47.

¹⁸³ Lori Boghardt, *Saudi Arabia’s Shifting War on Terror*, WASH. INST. FOR NEAR EAST POLICY (Aug. 18, 2014), <http://www.washingtoninstitute.org/policy-analysis/view/saudi-arabias-shifting-war-on-terror>.

¹⁸⁴ Tom Arnold, *UAE Strengthens Enforcement Against Money Laundering*, NAT’L, May 1, 2014, <http://www.thenational.ae/business/industry-insights/finance/uae-strengthens-enforcement-against-money-laundering>.

¹⁸⁵ Cohen, *supra* note 5, at 46-47.

¹⁸⁶ Hamzeh, *supra* note 56, at 79.

¹⁸⁷ *Id.*

In most Gulf States the executive branch continues to derive the power to oversee the implementation of the judicial process from its traditional role overseeing the sharia system.¹⁸⁸ In places like Saudi Arabia where the King oversees the implementation of sharia and law, international pressure on the King to enforce anti-funding laws has directly led to enforcement improvements because of the administrative influence the King exerts over the judiciary.¹⁸⁹ The King retains the constitutional authority to ensure laws are being enforced and that judicial proceedings are carried through to completion.¹⁹⁰ The same system cannot be found in Qatar.

Qatar's judicial complex is distinguished in having an established independence from the executive as a result of the dominance of the civil courts.¹⁹¹ From its genesis during British colonial rule this legal tradition has engrained itself into the fabric of Qatari society.¹⁹² The rise of the civil courts has diminished the role of both the sharia courts¹⁹³ and the Emir¹⁹⁴ in the judicial process. Under the current system, as the Amended Constitution guarantees, the degree of independence Qatar's judicial complex enjoys is inviolable.¹⁹⁵

Qatar's judicial development has weakened the Emir's constitutional ability to oversee and enforce laws through the judicial system. International pressure on the Emir to enforce Qatar's anti-financing laws has faltered because of the practical domestic limitations of the executive's power over the judiciary. This constitutionally mandated independence has not only curtailed the Emir's ability to enforce laws, it has also insulated the government from any accountability for a continuing failure to improve enforcement, further blunting international pressure for action.

Whether private citizens of Qatar continue to fund terrorist organizations alone or with the acquiescence of the Qatari royal family, the development of the judiciary is the crucial link for efforts to improve the state's financial sector. While the solution this article posits may at first

¹⁸⁸ *Id.* (“[T]his is not to suggest that dualism does not exist in the legal systems of Saudi Arabia, Kuwait, Bahrain and the United Arab Emirates (UAE). Dualism, however, in these systems is invisible rather than visible. All four dynasties rule on the basis of Islamic legitimacy and the sharia law.”).

¹⁸⁹ *See* Ansary, *supra* note 111.

¹⁹⁰ *Id.*

¹⁹¹ *See* PERMANENT CONSTITUTION, *supra* note 106, at arts. 129-31.

¹⁹² *See* Hamzeh, *supra* note 56, at 82.

¹⁹³ Hamzeh, *supra* note 56, at 89.

¹⁹⁴ *Id.* at 79.

¹⁹⁵ Kehdr, *supra* note 89; *see also* PERMANENT CONSTITUTION, *supra* note 106, at arts. 129-31.

appear unorthodox, it is legitimized by the history and culture of the region. The international community should encourage Qatar's Emir to set forth restrained measures increasing the executive branch's authority over varying aspects of the judicial process. If strategically enacted, this reform will allow the Emir to more assertively oversee the judicial bureaucracy's operation in enforcing regulations like the CMLTF Law. It will also make international efforts to pressure Qatar's government to enforce these laws more effective.

1. Solution: Increasing the Emir's Control over the Judiciary

Decrees from the Emir establishing stronger executive checks on the judicial branch would mark a shift in Qatar's constitutional balance. The legal culture of an independent judiciary has developed extensively in Qatar.¹⁹⁶ But although "the supremacy of law [not the Emir] is the base of rule in the state," it is important to keep in mind that Qatar's government remains an authoritarian regime and the Emir (if enticed to expend the political and social capital) retains the sovereign power to establish any law.¹⁹⁷ The former Emir Hamad bin Khalifa al-Thani's unilateral executive decision to implement a new national constitution serves as a reminder of this ability.¹⁹⁸ Although reform should remain restrained to avoid significant shifts upending the established social balance, the executive in Qatar maintains considerable authority and public trust to use as leverage to promulgate reform.¹⁹⁹

Several additional factors provide legitimacy to the Emir taking a more assertive stance in the judicial process. While Qatar's recent history has been dominated by a climate of judicial independence, the greater history of the Qatari people should not be discounted.²⁰⁰ Even in modernity, Qatar remains grounded as a society in its ancient roots as a tribal culture in which the sheikh historically took an active role in enforcing justice as an arbitrator of the people.²⁰¹ This role continued into

¹⁹⁶ See Hamzeh, *supra* note 56, at 79.

¹⁹⁷ PERMANENT CONSTITUTION, *supra* note 106, at art. 129; see also KAMRAVA, *supra* note 3, at 15 (noting that despite its popularity, and pretenses of democracy the Emir's regime in Qatar remains authoritarian in nature).

¹⁹⁸ Hugh Miles, *Al-Jazeera: The Inside Story of the Arab News Channel that is Challenging the West*, DENVER POST, Feb. 13, 2006, http://www.denverpost.com/excerpts/ci_0002706197.

¹⁹⁹ KAMRAVA, *supra* note 3, at 14 ("The system remains remarkably stable not so much because of its inherent authoritarianism but because its popular legitimacy among an overwhelming majority of Qatari nationals.").

²⁰⁰ See Hamzeh, *supra* note 56, at 80-83.

²⁰¹ See *id.* at 80.

the pre-colonial era when the sharia system dominated judicial proceedings and the Emir remained as a source for the people to appeal an unfavorable verdict.²⁰² A return for the Emir to an active role in the legal process would neither be revolutionary nor inappropriate but rather an acceptable development for Qatari society.

Statutory authority can also be found in the context of counterterrorism efforts. Article 41 of the CMLTF Law authorizes executive officials the broad authority to “issue or make regulations, directives, rules, recommendations or other instruments ... for the purpose of fighting against money laundering and terrorism financing.”²⁰³ This provision recognizes that the security threat posed by terrorist activity necessitates what democratic governments in Europe and North America have long constitutionally perceived: the need for heightened executive action in the face of national security threats.²⁰⁴ The U.S. federal government, as an example, has drastically expanded the executive’s capacity to respond to the modern threat of terrorism allowing for the development of extensive surveillance and security apparatuses.²⁰⁵ Pursuant to Article 41, the Emir could validate an increase in the capacities of the executive branch reasoning that the global and domestic benefits derived in the financial sector outweigh concessions to judicial independence.²⁰⁶

Understanding this, the authority exists for the Emir to implement effective controls to ensure that the judicial process properly enforces laws. The specific reforms envisioned by this article would come in the form of increases in the executive branch’s interaction with the judiciary in strategic areas to minimize constitutional infringements and maximize criminal enforcement. Regulations should address both the courts and the greater judicial bureaucracy.

In Qatar, the Supreme Judiciary Council is the body charged with judicial appointments to the various courts.²⁰⁷ The Emir can better leverage

²⁰² *Id.* at 81.

²⁰³ Law No. 4, *supra* note 122.

²⁰⁴ Jude McCulloch & Bree Carlton, *Preempting Justice: Suppression of Financing of Terrorism and the ‘War on Terror*, 17 CURRENT ISSUES CRIM. JUST. 397, 397-98 (2005).

²⁰⁵ *Id.* at 403.

²⁰⁶ See Law No. 4, *supra* note 122., at art. 41.

²⁰⁷ *The Judicial System*, QATAR MINISTRY OF FOREIGN AFFAIRS (2013), <http://www.mofa.gov.qa/en/Qatar/Pages/Judiciary.aspx>. See also PERMANENT CONSTITUTION, *supra* note 106, at art. 137 (“The judiciary shall have a Supreme Council to supervise the proper functioning of courts of law and their auxiliary organs. The law shall determine the composition, powers and functions of the said Council.”); see also Kehdr, *supra* note 89

his influence by asserting more control over this administrative body and clarifying his authority to suggest nominations, scrutinize appointments, and strengthen his ability to remove noncompliant judges.²⁰⁸ This authority would be similar to the appointment system in the United Arab Emirates where appointed judges are often connected to the ruling family and therefore more in line with its policies.²⁰⁹ The Emir could also establish a reporting system requiring judges to frequently report rulings to the executive as is done in Saudi Arabia.²¹⁰ These checks could incentivize otherwise apathetic courts to increase docket productivity and allow the Emir to more closely monitor the court system without violating the Amended Constitution's bar on influencing or interfering with court proceedings themselves.

More aggressive measures should come in increasing the executive's administration over the judicial bureaucracy outside of the courtroom. While the Amended Constitution provides express prohibition on executive interference in judicial rulings, it is less stringent in governing the preliminary phases of criminal matters.²¹¹ In many Gulf States, like Saudi Arabia, the King also inherently derives the authority to regulate this phase of proceedings from the responsibility to implement sharia.²¹² Without this inherent authority over the civil courts, the Emir should promulgate regulations to clarify the executive's authority and to accomplish more effective administration of the judicial process.

Under the CMLTF Law, the preliminary investigation and reporting of terrorism suspects falls under the responsibility of the FIU, while the prosecution of suspects is empowered to the Office of the Public Prosecutor.²¹³ These two institutions provide the key entry points to initiate

(noting that “the judiciary’s Supreme Council was set up in 1999 to ensure the independence of the judiciary. . .”).

²⁰⁸ Kehdr, *supra* note 89.

²⁰⁹ MARCI HOFFMAN, FOREIGN LAW GUIDE: UNITED ARAB EMIRATES-LEGISLATION AND JUDICIAL SYSTEM (2016), http://referenceworks.brillonline.com/entries/foreign-law-guide/ united-arab-emirates-legislation-and-the-judicial-system-COM_195302.

²¹⁰ Ansary, *supra* note 111 (“[T]he Council will prepare a comprehensive report containing all achievements, constraints and proposals, which will then be submitted to the King.”).

²¹¹ See PERMANENT CONSTITUTION, *supra* note 106, at art. 131.

²¹² Ansary, *supra* note 111.

²¹³ Law No. 4, *supra* note 122, at arts. 14, 20 (“Article 20- The Unit shall report to the Public Prosecution the findings of its examination and analysis when there are reasonable grounds to suspect that money laundering or terrorism financing acts have been committed.”).

the judicial process. Stringent regulations and checks on these bodies would likely result in improved enforcement. The Amended Constitution's silence over preliminary court proceedings allows the Emir greater authority to closely monitor and scrutinize the inner workings of both institutions. Executive action could include the hiring and removal of personnel, criminal charges against personnel found to be obstructing enforcement of the law, and conditional controls on each institution's budget.

These suggestions are posited as a starting point, but are not meant to be an exhaustive list. Even incremental regulations could make strategic, significant steps towards removing the constitutional and structural barriers blocking the executive branch from properly overseeing that counterterrorism laws are enforced.

2. *Leveraging Security Issues as a Catalyst for Reform*

The international community will likely need to persuade the Qatari government to initiate reforms to improve enforcement, which may prove difficult. Qatar's conservative government has likely avoided action to upend the current financial environment largely for perceived security reasons, especially (as this article posits) if it feels insulated from accountability by the structure of its constitution.²¹⁴ Qatar has long played a neutral role on the world stage, simultaneously hosting major American military installations alongside the only permanent office space for the Taliban.²¹⁵ This approach is part of a strategic balancing act to ensure domestic security by Qatar's leaders, who understand the strengths and limitations of the wealthy yet demographically small Gulf state.²¹⁶ As long as Qatar's leaders perceive that the longstanding security status quo remains, it may prove difficult to encourage domestic change that would cut off Qatari-based support for terrorist activities and possibly open up the Qatari homeland as a target for terrorist groups.²¹⁷

International developments changing this balance could provide the best leverage for the international community to engage Qatar.²¹⁸ There are encouraging signs that these developments may have materialized. Lori

²¹⁴ Boghardt, *supra* note 7.

²¹⁵ Alster, *supra* note 39.

²¹⁶ KAMRAVA, *supra* note 3, at 47 (arguing that Qatar has embraced a policy of asserting "smart power" on the international stage by recognizing its limitations imposed by size and demographics and embracing its strategic advantages).

²¹⁷ See Boghardt, *supra* note 7 ("[E]ven small changes in these countries' political calculations could give Washington opportunities to support positive action.").

²¹⁸ *Id.*

Boghardt argues that recent “alarming I[s]lamic State] gains in Iraq and Syria present a special opportunity for Washington to work with Qatar to enforce counterterrorist financing procedures.”²¹⁹ Already, Qatar has aided Western efforts against the Islamic State to an unprecedented degree.²²⁰ The 2014 public cooperation between Qatar and the United States in the coalition bombings of the Islamic State in Syria marks a stark departure from Qatar’s typically discreet foreign policy.²²¹

Boghardt concludes that Qatar will likely continue to strengthen its resolve in the War on Terror if the ruling family “perceives a direct threat from Syria-based groups that are supported by local donors, or if they believe that jihadists returning home from the Syrian conflict pose a domestic threat.”²²² The international community should leverage this evolving volatile environment and urge the Emir to take constitutional action.

3. *Concerns and Criticisms*

Calls for reform that empower an executive body to diminish judicial independence should be scrutinized and vetted no matter how restrained. Even in the light of domestic and international security concerns, the consolidation of more power in the hands of the executive of an autocratic government must be advocated for cautiously and only when necessary. During times of war and domestic unrest, the erosion of freedoms by the executive branch is often an unfortunate consequence that can be exploited for individual gain.²²³ Dr. Jude McCulloch observes that the “move towards preemptive criminal justice frameworks reverses the democratic ideal ... and replaces it with what Henry Giroux calls the ‘garrison state.’”²²⁴

The ideas advocated by this article acknowledge and accept these concerns as part of any workable solution. Suggesting the judicial branch relinquish limited aspects of autonomy to the executive branch by no means endorses the Emir to take on wide swaths of power in the name of the War on Terror, despite the Emir’s sovereign ability to do so. Though much of

²¹⁹ Boghardt, *supra* note 10.

²²⁰ Amena Bakr, *Qatar Joins Coalition Against ISIS, but Keeps Ties With Islamic Forces*, HAARETZ, Nov. 2, 2014, <http://www.haaretz.com/middle-east-news/1.624099>.

²²¹ *Id.* (noting that “Qatar was among the Gulf Arab states that sent its warplanes into action” against ISIS as part of the U.S. coalition against the terrorist group).

²²² Boghardt, *supra* note 7.

²²³ McCulloch, *supra* note 204, at 398.

²²⁴ *Id.*

the Persian Gulf's history has been marked by a respect for tribal leaders whose jurisprudence guides the greater good of the community, many modern oppressive regimes have abused this power at the expense of socioeconomic and political freedoms.²²⁵

Understanding that the development of Qatar's judicial system has created a major loophole in the regulation of its financial sector, this article posits that constitutional reform is ultimately necessary. By concentrating reform in several pressure areas, small shifts in the constitutional balance will likely result in comprehensive gains in legal enforcement of regulations like the CMLTF Law.

Various other suggestions have been made to pressure improvements in the financial sector in Qatar. These have included toughened U.S. Treasury Department sanctions,²²⁶ increased intelligence cooperation, diplomatic strategies, and human relations campaigns.²²⁷ All of these suggestions are useful tools for counterterrorist financing, but unless Qatar's poor judicial enforcement is addressed, outside techniques will remain ineffective. Therefore, the ideas posited by this article stand as the most practical solutions to the constitutional root of the existing problem.

III. CONCLUSION

On September 25, 2014 Emir Tamim bin Hamad al-Thani appeared on CNN seeking to assure American audiences of Qatar's commitment in the fight against the financing of terrorist organizations.²²⁸ During the appearance, the Emir cited his nation's "strong law" (the CMLTF Law) as a major part of the state's robust efforts against terrorist financing.²²⁹ The Emir made no mention, however, of the continuing concerns regarding Qatar's enforcement of its laws.²³⁰

International efforts to pressure Qatar to improve enforcement of its counterterrorism financing laws have largely been to no avail. This article argues that Qatar has remained a sanctuary for terrorist financing activity because of the independent nature of its court system. If the U.S. government and international community can successfully pressure the

²²⁵ See Hamzeh, *supra* note 56, at 81.

²²⁶ See generally Cohen, *supra* note 5, at 46.

²²⁷ Michael Jonsson & Svante Cornell, *Countering Terrorist Financing: Lessons From Europe*, 8 GEO. J. INT'L AFF. 69, 77 (2007).

²²⁸ Krevar, *supra* note 50.

²²⁹ *Id.*

²³⁰ *Id.*

Emir to take a more assertive role in the judiciary, subsequent effort's to pressure the Qatari government to enforce counterterrorist financing laws will enjoy more success.

Qatar is a major missing link in successfully waging the War on Terror that can no longer be ignored. The state sits in an influential position in world affairs and should be held accountable to act under the expectations of a responsible state actor. The Emir must reassert his historical role in Qatar's judicial process to ensure counterterrorist financing regulations are enforced and that significant strides to improve the security of the overall international financial system can be made.