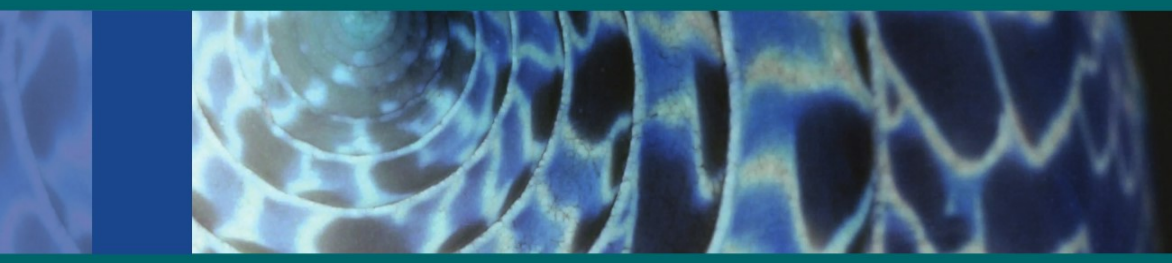
Antoine Masson
Mary J. Shariff
Editors



Legal Strategies

How Corporations Use Law to Improve Performance

Springer

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Antoine Masson • Mary J. Shariff
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Foreword

This book is an important development in the emerging field of law and management. Editors Antoine Masson and Mary J. Shariff have assembled an impressive array of chapters that further embed law in mainstream theories of business strategy[1] and provide additional empirical support for early assertions that managers can use the law to create value and manage risk.[2]

Law affects each of the five forces that determine the attractiveness of an industry: buyer power, seller power, the competitive threat posed by current rivals, the threat of new entrants, and the availability of substitutes.[3] Law affects the internal organization of the firm, the allocation of firm resources among stakeholders, the marshaling of human resources and capital, and the uniqueness of resources. For example, patents create barriers to entry and limit the availability of substitutes,[4] and trademarks protect brand equity.[5]

Legal astuteness – the ability of a top management team to work effectively with counsel to solve complex problems – can be a source of competitive advantage under the resource-based view of the firm.[6] Legally astute managers call on their lawyers to play an active and ongoing role in formulating and executing firm strategy. They demand legal advice that is business oriented, and they expect their lawyers to help them address business opportunities and threats in ways that are legally permissible, effective and efficient.

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[1]See for example, A. Belcher at Chap. 11 and C. Roquilly at Chap. 2.

[2]See for example, C.E. Bagley, "Legal Problems Showing a Way to Do Business," Financial Times (27 November 2000) 2. See also G.J. Siedel, Using Law for Competitive Advantage (Jossey-Bass, 2002).

[3]M.E. Porter, "How Competitive Forces Shape Strategy," M.E. Porter, *On Competition* (Harvard Business School Press, 1996) 21–22. For an excellent discussion of how law affects the five forces, see G.R. Shell, *Make the Rules or Your Rivals Will* (Crown Business, 2004).

[4]See D. Lim at Chap. 20.

[5]See R.D. Petty at Chap. 15.

[6]See C.E. Bagley, "Winning Legally: The Value of Legal Astuteness" (2008) 33 Academy of Management Review 378–390.

In environments in which a high degree of legal astuteness is needed, it may be necessary to form what Clark and Wheelwright[7] call "heavyweight teams," comprised of managers and in-house lawyers. Members of heavyweight teams do not just represent their functional group. Instead, they act as general managers with responsibilities for the success of the entire project.

Nelson and Nielsen found that roughly 25% of the responding in-house counsel were members of senior management, based on their titles.[8] Because the functional backgrounds of the top managers and power relations are related to a firm's strategy,[9] the inclusion of lawyers in the top management team can be expected to affect the alternatives and the strategic choices considered.[10] Bringing together individuals, such as lawyers and managers, from different "thought-worlds" may increase access to historical perspectives and multiple functional areas,[11] enhance problem solving by widening scanning activities,[12] and reduce group-think by prompting greater disagreement,[13] but at the cost of increasing team conflict and head-butting as different people use their own specialised languages, images, and stories.[14] It may also decrease interpersonal communication and reduce perceived effectiveness.[15]

To achieve "internal integration,"[16] problem-solving must be tightly connected across departmental boundaries and the costs associated with functional diversity must be overcome.[17] It is clear that "simply changing the structure of teams (i.e. combining representatives of diverse function and tenure) will not improve performance. The team must find a way to garner the positive process effects of diversity and to reduce the negative direct effects."[18] To bridge this kind of professional gap, managers and counsel must learn how to make explicit the key assumptions

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[7]K.B. Clark and S.C. Wheelwright, "Organizing and Leading Heavyweight Development Teams" (1992) 34 California Management Review 9–28 [Clark and Wheelwright].

[8]R.L. Nelson and L.B. Nielsen, "Cops, Counsel, and Entrepreneurs: Constructing the Role of Inside Counsel in Large Corporations" (2000) 34 Law and Society Review 457–494.

[9]S. Finkelstein, "Power in Top Management Teams: Dimensions, Management, and Validation" (1992) 35 Academy of Management Journal 505–538.

[10]M.L. Tushman and E. Romanelli, "Organizational Evolution: A Metamorphosis Model of Conveyance and Reorientation," L.L. Cummings and B.M. Staw eds., *Research in Organizational Behavior*, vol. 7 (Elsevier, 1985) 171–222.

[11]D.G. Ancona and D.P. Caldwell, "Demography and Design: Predictors of New Product Team Performance" (1992) 3 Organization Science 323 [Ancona and Caldwell].

[12]S.L. Keck, "Top Management Team Structure: Differential Effects by Environmental Context" (1997) 8 Organization Science 143–156 [Keck].

[13]C.C. Miller, L.M. Burke and W.H. Glick, "Cognitive Diversity Among Upper-Echelon Executives: Implications for Strategic Decision Processes" (1997) 19(1) Strategic Management Journal 39–58.

[14]Ibid.

[15]Keck (n 12).

[16]Clark and Wheelwright (n 7).

[17]Ancona and Caldwell (n 11).

[18]Ibid 338.

underlying their reasoning and engage in meaningful face-to-face interactions with others to address complex and conflicting issues. Decisions in one function can then take into account the skills and concerns of the other function.

In certain environments, where the firm faces legal uncertainties and contingencies that affect resources critical to the firm's survival, boards may select lawyers to serve as chief executive officers.[19] In recent years, the number of CEOs who began their careers as lawyers increased by 100%.[20] As of 2004, 10.8% of the CEOs of companies in Standard & Poor's 500-stock index had law degrees.[21]

There is a risk that including lawyers on management teams will result in their being "co-opted" by the non-lawyer managers and thereby lose their objectivity. In particular, "[T]o the extent that general counsel participates at an early stage in shaping major transactions and corporate policy, counsel's ability to bring detached, professional judgment to bear in accessing their legality may be comprised, especially when the question of legality is tinged in shades of grey as opposed to black and white."[22] Auerbach argued that this potential loss of objectivity makes it inappropriate for inside counsel to be involved in strategic planning unless the plans are vetted by independent outside counsel.[23] The risk of co-option may be particularly acute for "many lawyers [who] actively seek to join the ranks of senior management and leave the legal department altogether."[24]

This problem of co-option may make it necessary to ensure that certain in-house and outside lawyers are kept separate from the top management team so they can objectively evaluate the legality of proposed actions. This important monitoring function is akin to that performed by internal and external auditors. Thus, it may be appropriate to locate in-house lawyers geographically near the business units for purposes of contract negotiation and most other legal matters, but to centralise regulatory functions, such as antitrust, environmental, and securities law compliance, at the firm's executive headquarters to avoid undue identification with any given business unit. If the general counsel is a member of the top management team, then it may be necessary for the board of directors to appoint a senior lawyer who reports directly to the audit committee to act as an independent chief compliance officer.

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[19]J. Pfeffer and G.R. Salancik, *The External of Organizations:Resource Dependence Perspective* (Stanford University Press, 2003).

[20]S.M. Kim, "Dual Identities and Dueling Obligations: Preserving Independence in Corporate Representation" (2001) 68 Tennessee Law Review 179–260 [Kim].

[21]M. France and L. Lavelle, "A Compelling Case for Lawyer-CEOs," BusinessWeek (13 December 2004) 88.

[22]D.A. DeMott, "Colloquium Ethics in Corporate Representation: The Discrete Roles of General Counsel" (2005) 74 Fordham Law Review 955–981.

[23]J. Auerbach, "Can Inside Counsel Wear Two Hats?" (1984) 62(5) Harvard Business Review 80–87.

[24]Kim (n 20) 206.

Although many tools, such as securitization, can be used to create value for multiple stakeholders and need not be "negative or nefarious,"[25] the dramatic collapse of the subprime mortgage market in 2008 is a striking example of how securitization of mortgages without proper regard for the debtor's ability to repay the loan can have disastrous effects. Similarly, although derivatives can be effective tools to manage risk, they can also be misused by activist hedge funds to evade disclosure requirements.[26] Contracts can fill regulatory gaps and lawyers can serve as "creative legal engineers" and "transaction cost engineers"[27] who facilitate legitimate global business transactions. But "creative compliance"[28] and taking advantage of unintended legal loopholes can thwart the rule of law. Legally astute managers appreciate the importance of complying with both the letter and the spirit of the law.[29] They understand that "business decisions consist of continuous, interrelated economic and moral components"[30] and that "the moral aspects of choice" are the "final component of strategy."[31] It is critical to keep this in mind when evaluating the corporate legal strategies described in the chapters that follow.

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[25]D.L. MacPherson at Chap. 12.

[26]E. Hellebuyck at Chap. 13.

[27]R.J. Gilson, "Value Creation by Business Lawyers: Legal Skills and Asset Pricing" (1984) 94 Yale Law Journal 239.

[28]D. McBarnet and C. Whelan, "Creative Compliance and the Defeat of Legal Control: The Magic of the Orphan Subsidiary," K. Hawkins ed., *The Human Fact of Law* (Oxford University Press, 1997).

[29]Bagley (n 6).

[30]D.L. Swanson, "Addressing a Theoretical Problem in Reorienting the Corporate Social Performance Model" (1995) 20 Academy of Management Review 43.

[31]E.P. Learned, C.R. Christensen, K.R. Andrews and W.D. Guth, *Business Policy: Text and Cases* (Irwin, 1969) 578.

Preface

In order to optimize competitiveness, corporations frequently contemplate and incorporate aspects of legal systems, legal processes and legal players, such as litigation and lawyers, into their long-term strategic decision making processes. These types of strategies, i.e. ones that incorporate law and legal resources, are the subject of increased focus and scrutiny in current legal literature and scholarly analysis.

The term 'strategy' in its historical and/or traditional sense, is associated with the organized movement of armies in war. Today, the term has also come to encompass a broader perspective, denoting the art of devising and implementing a skilled and systematic plan of action in order to reach a given objective. Hence, plans of action by corporations that involve the evaluation, incorporation and manipulation of law, legal frameworks and legal players in order to increase the bottom line, can be described as corporate legal strategies.

Notwithstanding the foregoing however, not every corporate strategy related to law can or should be regarded as a true legal strategy.

Current academic literature describes legal strategy as a strategy rooted in the perception that the law, the court, legal rules and procedure, etc., can be readily manipulated so as to achieve a specific outcome. This strategic perception of the constraint and role of law is perhaps most readily illustrated by the methods and tactics employed in the area of litigation, whereby parties and their lawyers attempt to construct a specific legal outcome through strategies involving, for example, forum shopping and procedural delay.

Conversely, corporate economic planning that integrates the legal environment into business strategy is rejected as a true legal strategy on the basis of what appears to be a widely accepted premise that corporations perceive the law as static and supreme. Under this view, the corporation regards the law as a necessary restriction in respect of firm business such that all it can do is try to make the best out of a restrictive situation and seek advantage from within the superior legal framework.

Certainly, economic strategy within a legal framework premised on the view that the law is supreme arguably does not amount to a "true" legal strategy. However, it

is also apparent that not all corporations view the law so simplistically, i.e. as a necessary facet of the business environment. Rather, many companies adopt what can be described as a 'legal management approach' whereby long-term business strategies are formulated through active assessment of the interaction of legal systems, processes and players. Hence, while there has been some academic resistance to the existence of true corporate legal strategy, it is clear that corporations are engaging in legal strategy premised on the view that the law is malleable.

With the above in mind, the first goal of this book is to identify, describe and critique current theories of corporate legal strategy. To this end, two relevant tracks can be observed: litigation and/or the adversarial process; and corporate practices with respect to long-term business planning.

The second goal is to identify, through the use of case studies, legal strategies based on the mobilization and allocation of legal resources within a corporation.

The third goal of this book is to identify and evaluate the legitimacy of regulatory responses, if any, that attempt to minimise the impact of a particular legal strategy on the business market. Thus, this book also explores regulatory competition law from the corporate perspective.

The overall objective of this book is to assist in the development of legal strategy theory and a precise definition of corporate legal strategy. Thus, this text is less concerned with examining the impact of legal norms on the corporate business environment and more concerned with exploring how corporations develop and implement "vertical" strategies (those between the corporation and regulatory bodies) and "horizontal" strategies (those between competitors outside or inside the same legal system). We hope that exploring corporate activities from this vantage point will not only assist in the development of an accurate definition of corporate legal strategy, but will also assist in identifying the methods by which law, rightly or wrongly, can be transformed into a mere corporate resource.

Luxembourg — Antoine Masson
Canada — Mary J. Shariff
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Chapter 1
Introduction

D. Trevor Anderson

This diverse and provocative collection of papers by authors from different countries, economic regimes and legal systems and traditions, makes for fascinating and perhaps at times uncomfortable reading. It should be of great interest to lawyers, and perhaps even more so to corporate executives, particularly those whose enterprises operate in the global economy.

This collection begins to chart what is coming to be recognized as a new field of study, now only partly discovered, with much awaiting further exploration. It asks what role legal strategic planning has or may have in the decisions made and directions taken by business corporations, using law, not just as datum or context – such as liability risk – but as a core element of executive thought and action. Accordingly, the study of corporate legal strategy requires examination beyond the role of law as a mere constraint, i.e. economic strategy within a legal framework, to focus instead on how "the law" – along with its systems, processes, policies, players, perceptions and norms – is evaluated, incorporated or manipulated by firms to optimise competitiveness. This exploration therefore canvasses the question: What legal choices/means may be adopted to achieve a desired business or economic outcome?

Broadly put, the responses fall into two potential divisions.

One – which can be described as the "vertical" dimension of the subject – concerns ways in which a firm may, as a litigant or party, influence the legal or economic outcome of litigation or a regulatory process. In this book, contributors discuss, often with concern for a larger public good, the effect of time and complexity in litigation strategy;[1] the use of economic and game theory to chart or predict conflict resolution strategies that in the face of cost or other disadvantages

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[1]See for example, L.M. Lopucki and W.O. Weyrauch at Chap. 4; A. Masson at Chap. 3; D. Danet at Chap. 8; and D. Rossa Phelan at Chap. 16.

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will be thought most likely to produce the optimal realizable result;[2] the uneven playing field between parties in tax litigation;[3] strategies for influencing litigation by the collection and presentation of evidence;[4] means that were adopted to secure "lighter" public regulation of hedge funds;[5] the flight from the Courts to alternative dispute resolution methods;[6] the potential for adopting, appropriating or manipulating ADR to realize intended outcomes;[7] and so on.

The second theoretical division of the subject – its "horizontal" dimension – is the use of legal strategies on an ongoing basis to secure competitive advantage against corporate competitors. Various essays consider legal strategic capacities within firms,[8] how firms can integrate legal strategy within their corporate planning,[9] how corporations may seek to avoid liability under modern statutes imposing criminal culpability in some circumstances,[10] how in emerging states with limited business law and regulation, investing parties have, by agreements, created legal regimes favourable to their purposes,[11] means by which manufacturers seek to ride on another firm's established brand,[12] and, very important today, the importance of intellectual property protection to economic security and dominance.[13] Of course, all these examples of strategy serving the apparent economic benefit of a corporation raise grave issues of morality in public policy. Light or inadequate regulation of financial markets or instruments may look quite different in 2009 than it did in 2007! Accordingly, contributors draw attention to the responses that may be made by the state to self-interested corporate projects, and which then themselves must become part of the strategic planning environment.[14] The laws and public policy of the state may seem at times to point in different directions: while protection of intellectual property may be seen as sound policy, too extensive or complete a monopoly will curtail or eliminate competition, also seen as serving the public good.[15]

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[2]See for example, R. Macey-Dare at Chap. 7; A. Masson at Chap. 6; B. Bolaños-Guerra, G. Dupont and E. Picavet at Chap. 5; and B. Aliouat at Chap. 14.

[3]See for example, L.M. Lopucki and W.O. Weyrauch at Chap. 4; and D. McBarnet at Chap. 18.

[4]See for example, T. Manoir de Juaye at Chap. 17.

[5]See for example, E. Hellebuyck at Chap. 13.

[6]See for example, M.J. Shariff, M. Pomrenke and V. Hilder at Chap. 9.

[7]Ibid.

[8]See for example, C. Roquilly at Chap. 2; A. Belcher at Chap. 11; D. McBarnet at Chap. 18; and B. Aliouat at Chap. 14.

[9]Ibid.

[10]See for example, D. MacPherson at Chap. 10.

[11]See for example, D. McBarnett at Chap. 18.

[12]See for example, R. Petty at Chap. 15.

[13]See for example, B. Aliouat at Chap. 14.

[14]Ibid; See also for example, E.I. Hyslop at Chap. 19 and discussions in A. Masson at Chap. 3; and M.J. Shariff, M. Pomrenke and V. Hilder at Chap. 9.

[15]See for example, D. Lim at Chap. 20.

In trying to arrive at a theory of corporate legal strategy, the response can also be approached from the differing theoretical perspectives such as the judicial approach,[16] the cognitive approach,[17] the systemic approach,[18] the economic approach[19] or the law and management approach.[20]

Beyond these theoretical divisions and perspectives however, the strategies and perspectives discussed herein also lend support to the suggestion that law is a resource to be mobilized and aligned with business and economic agendas. Thus examination of legal strategy also requires consideration of the increasing sophistication of this alignment which has been aptly coined "legal astuteness" by Constance E. Bagley,[21] the perceptions and influence of the players involved,[22] and whether there is any uniformity or similarity in strategies implemented. Such considerations in turn raise additional questions regarding the potential misuse of strategies for socially and ethically unacceptable purposes.

Taken together, the contributions within this book portray something of the character, potential and challenge of "legal strategy", and provide much good fodder for thought and controversy. However, this is but a start. Much more remains to be done at the theoretical and practical levels before we can adequately understand this subject and all its implications. One can readily imagine another book, responding to the ethical questions raised by the very modern version of legal realism asserted herein and otherwise challenging and responding directly to these essays as well as another book dedicated to public and state responses to corporate legal strategies and the enlarged role and responsibility of regulators, particularly in light of what is currently emerging in the wake of the financial excesses and failures of the immediate past.

If, as one hopes, such further studies and debates now follow, the editors and authors of this pioneering volume will deserve much credit, as they now deserve thanks for opening this field of corporate activity to our view.

[16]See for example, L.M. Lopucki and W.O. Weyrauch at Chap. 4.

[17]See for example, A. Masson at Chap. 6; and D. Danet at Chap. 8.

[18]See A. Masson at Chap. 6.

[19]See for example, R. Macey-Dare at Chap. 7.

[20]See for example A. Belcher at Chap. 11; and B. Aliouat at Chap. 14.

[21]C.E. Bagley, "Winning Legally: the Value of Legal Astuteness" (2008) 33(3) Academy of Management Review 378.

[22]See for example L.M. Lopucki and W.O. Weyrauch at Chap. 4; and P.J. Zwier and D.C. Siemer at Chap. 21.

Part I
Theorizing Legal Strategies

Chapter 2
From Legal Monitoring to Legal Core Competency: How to Integrate the Legal Dimension into Strategic Management

Christophe Roquilly

Abstract Strategic Management does not ignore legal reality but the impact of legal parameters on strategy of the firm is not sufficiently formalised. In this paper, the author proposes to formalise the way in which a firm's recourse to the law can maintain or generate a sustainable competitive advantage. The development of a core legal competency requires the recognition of a legal capability within the firm. This capability can be defined as the firm's ability to create legal resources which includes taking into account legal elements from the external environment so as to secure and increase the value of other resources. Legal mechanisms as key factors in a firm's environment are first highlighted. These mechanisms must be associated with or connected to the company's resources. The role of internal legal resources is then examined along with the need to recognise legal capability. The author concludes with an examination of how legal resources and legal capability can be a source of sustainable competitive advantage.

2.1 Introduction

This book focuses on legal strategies and the ways in which firms manage legal disputes, improve compliance in order to reduce legal risk and exploit their innovations in accordance with their corporate strategy. The contribution of this book is obvious: it demonstrates that the law is no longer viewed as an exogenous constraint to which companies must adapt but as something that can be anticipated, analysed and organized in respect of company objectives and corporate projects. By moving beyond an excessively positivist approach to law and by adopting a resolutely proactive position, companies recognise the strategic value of the law.

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Indeed, the legal dimension has found its way into the field of management and strategy research. The legal dimension is present in the Industrial Organization model, where the political and legal segment is recognised as a part of the general environment.[1] Attention has also been drawn to its contribution to the development of Strategic Industry Factors and its inclusion in environmental factors.[2] As for the analysis of a firm's internal resources which can generate a competitive advantage, legal instruments such as contracts or intellectual property rights will sometimes be included.[3] But despite all these efforts to recognise the law and its diverse components and manifestations as an integral part of strategic management, the process by which the use of legal resources can generate a sustainable competitive advantage has yet to be formalised.

In a study devoted to the resource-based view, Newbert[4] refers neither to legal resources nor legal capability in the list of independent variables. A "regulatory" core competence is cited but only appears in one article on the sample developed by the author. In a recent paper, Argyris and Mayer[5] focus on contract design as a firm capability, moving one step further in the integration of the legal dimension into strategic management. Bagley,[6] in an article published in the Academy of Management Review, highlights what she calls "legal astuteness" and defined as a competence that can assist a firm's quest for competitive advantage. It would therefore appear that a true process of reflection has begun in order to make the law and legal decision-making more visible in strategic management. This is apparent from various papers in legal and management journals and is a trend that must be pursued. In this paper, I therefore propose to formalise the way in which a firm's recourse to the law can maintain or generate a sustainable competitive advantage. First, I highlight certain legal mechanisms key to a firm's environment and connect them to the company resources. I then look at the role of the firm's internal legal resources along with the need to recognise and/or identify its legal capability. I conclude by examining how legal resources and legal capability can be a source of sustainable competitive advantage.

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[1]M.E. Porter, *Competitive Strategy: Techniques for Analyzing Industries and Competition* (Free Press, 1980).

[2]G.S. Hansen, and B. Wernerfelt, "Determinants of Firm Performance: the Relative Importance of Economic and Organizational Factors" (1989) 10(5) Strategic Management Journal 399 [Hansen and Wernerfelt]; R. Amit, and P.J.H. Shoemaker, "Strategic Assets and Organizational Rent" (1993) 14(1) Strategic Management Journal 33 [Amit and Shoemaker].

[3]R. Hall, "Strategic Analysis of Intangible Resources" (1992) 13(2) Strategic Management Journal 135.

[4]S.L. Newbert, "Empirical Research on the Resource-Based View of the Firm: An Assessment and Suggestions for Future Research" (2007) 28(2) Strategic Management Journal 121.

[5]N. Argyris, and K.J. Mayer, "Contract Design as a Firm Capability: An Integration of Learning and Transaction Cost Perspectives" (2007) 32(4) Academy of Management Review 1060.

[6]C.E. Bagley, "Winning Legally: The Value of Legal Astuteness" (2008) 33(2) Academy of Management Review 378.

2.2 External Legal Considerations as Strategic Industry Factors

External legal considerations refer to legal decisions made outside of the firm but within its environment. Such decisions, which must be identifiable and anticipated by the firm, carry a certain amount of risk. The risk might constitute either a threat or an opportunity and can therefore influence company strategy. In other words it requires a response or an internal decision in line with strategic objectives.

2.2.1 The Legal Sphere: A Source of Both Threats and Opportunities that Must Be Detected

2.2.1.1 The Legal Sphere as a Set of Risks, Threats and Opportunities

The firm's external environment necessarily includes the legal dimension of regulation. The role of regulation on a firm's decision-making is widely recognised either as an aspect of its environment or as a non-market issue.[7] The importance of the regulatory environment increases in accordance with State efforts to make it a competitive advantage with a view to attracting entrepreneurs and investors alike.[8] It is also important to note that there can also be factors applicable only to specific industry environments, some of which might carry obligations similar to those contained in legislative or regulatory provisions. The same consideration applies, in certain cases, to professional or commercial norms and even codes of good practice for example.

The external environment also includes the competitor environment which also carries factors belonging to the legal sphere. For example, intellectual property rights in the portfolios of competing firms,[9] methods of defence against hostile

[7]Hansen and Wernerfelt (n 2); Amit and Shoemaker (n 2); P. Ghemawat, *Strategy and the Business Landscape: Core Concepts* (Prentice Hall, 2001); V.K. Aggarwal, "Corporate Market and Non-market Strategies in Asia: A Conceptual Framework" (2001) 3(2) Business and Politics 89; D. Baron, *Business and Its Environment*, 4th ed. (Prentice Hall, 2003); P.S. Ring, G.A. Bigley, T. D'Aunno, and T. Khanna, "Perspectives on How Governments Matter" (2005) 30(2) Academy of Management Review 308.

[8]M.E. Porter, "The Competitive Advantage of Nations", M.E. Porter ed., *On Competition* (Business School Press, 1996) 155.

[9]W. Cohen, R. Nelson, and J. Walsh, "Protecting Their Intellectual Assets: Appropriability Conditions and Why U.S. Manufacturing Firms Patent (or Not)" (2000) Working Paper No. 7552 National Bureau of Economic Research, online: http://www.nber.org/papers/w7552 [Cohen, Nelson and Walsh]; R. Bekkers, G. Duysters, and B. Verspagen, "Intellectual Property Rights, Strategic Technology Agreements and Market Structure: The Case of GSM" (2002) 31(7) Research Policy 1141; J. Gibson, "Risk Aversion and Rights Accreditation in Intellectual Property Law" (2007) 116(5) The Yale Law Journal 882 [Gibson].

takeovers[10] and closed distribution networks using exclusive or selective distribution contracts[11] all constitute legal factors that may adversely affect or threaten a firm's strategic objectives. Legal threat can therefore be defined as an element of the legal sphere that can damage the actions a firm takes in order to acquire a strategic advantage.[12] However, there is real difficulty in distinguishing between threat and mere constraint, risk or uncertainty.[13] The term "risk" does not itself enjoy a definition that is widely accepted.[14] For Beck,[15] "risk is a systematic way of dealing with hazards and insecurities included and introduced by modernisation itself [. . .] it does thus initially only exist in terms of the (scientific or anti-scientific) knowledge about them. They can thus be changed, magnified, dramatised, or minimised within knowledge and to that extent they are particularly open to social definition and construction".

Therefore, legal risk can take the form of, for example:

- Regulatory pressure, which places a limit on diversity and thereby restricts the number of possible options in terms of resources[16]
- Vagueness or instability of legislative or regulatory texts, or case-law.

According to Verdun,[17] legal risk is the result of an encounter – or confrontation – between a legal norm and a particular event that has considerable consequences. Collard[18] defines it as the same encounter but with consequences that may affect the

[10]See J.N. Gordon, "What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections" (2002) 69(3) The University of Chicago Law Review 1233 ["What Enron Means"]; L.A. Bebchuk, J. IV Coates, and G. Subramanian, "The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence and Policy" (2002) 54(5) Stanford Law Review 885; S. Hannes, "A Demand-Side Theory of Antitakeover Defenses" (2006) 35(2) Journal of Legal Studies 475.

[11]F.M. Scherer, "Retail Distribution Channel Barriers to International Trade" (1999) 66(1) Antitrust Law Journal 77; C. Collard, and C. Roquilly, "Closed Distribution Network and E-Commerce: Antitrust Issues" (2002) 16(1) International Review of Law Computers and Technology 81; A.I. Gavil, "Exclusionary Distribution Strategies by Dominant Firms: Striking a Better Balance" (2004) 72 Antitrust Law Journal 3.

[12]V. Prior, "The Language of Competitive Intelligence: Part Four" (1999) 10(1) Competitive Intelligence Review 84.

[13]J. Dutton, and S. Jackson, "Discerning Threats and Opportunities" (1998) 33 Administrative Science Quarterly 370; P. Chattopadhyay, W. Glick, and G.P. Huber, "Organizational Actions in Response to Threats and Opportunities" (2001) 44(5) Academy of Management Journal 937 [Chattopadhyay, Glick and Huber].

[14]O. Renn, "Three Decades of Risk Research: Accomplishments and New Challenges" (1998) 1(1) Journal of Risk Research 49.

[15]U. Beck, *Risk Society: Towards a New Modernity* (Sage, 1992) 21.

[16]C. Oliver, "Sustainable Competitive Advantage: Combining Institutional and Resource-Based Views" (1997) 18(9) Strategic Management Journal 697.

[17]F. Verdun, *La Gestion des Risques Juridiques* (Editions d'Organisation, 2006).

[18]C. Collard, "Le Risque Juridique Existe-t-il? Contribution à la Définition du Risque Juridique" (2008) 1 Cahiers du Droit de L'Entreprise 8.

value of the firm and/or threaten its objectives. There is no standard definition of legal risk and Whittaker[19] questions as to whether it would actually be useful to produce one. The detection, analysis and handling of risks that emerge from the legal sphere fall into the domain of "legal risk management".

Additionally, the legal sphere often generates provisions with attendant risks that can actually prove to be positive for firms, i.e. risks can sometimes be opportunities that allow firms to improve the performance of their day-to-day operations and management. This is an essential dimension of the law. That is, effective strategy requires that the legal sphere not be seen solely as an exogenous constraint to which firms must adapt in a passive and mechanical manner. For example, Lee, Peng and Barney demonstrate certain incentives for entrepreneurs arising out of a regulation pertaining to bankruptcy.[20] Similarly, Maijoor and Van Witteloostuijn reveal the rise in demand for certain services – auditing in particular – following a new regulatory development.[21] Indeed, developments in the legal sphere can in some cases constitute real opportunity as it can offer a firm the possibility of new business or the ability to undermine the choices made by competitors. Pfeffer and Salancik describe the external environment as an arena which firms try to influence with a view to controlling crucial resources, primarily by devising rules, regulating possession and enforcing regulations.[22] Such regulatory management, to use the term employed by Beardsley, Bugrov and Enriquez,[23] requires extensive knowledge of the potential strategic impact of different elements within the legal sphere.

2.2.1.2 The Necessity of Legal Monitoring

In order to ascertain the risks, threats and opportunities of the legal sphere, it is essential for firms to have a system of legal monitoring. Legal monitoring makes it possible to reduce the uncertainty associated with a firm's external environment and decrease its dependence on mere opinion and experience.[24] The search for information is a critical stage in problem-solving and applies to any field where

[19]A.M. Whittaker, "Lawyers as Risk Managers" (2003) 18(1) Journal of International Banking and Financial Law 5.

[20]S.H. Lee, M.W. Peng, and J.B. Barney, "Bankruptcy Law and Entrepreneurship Development: A Real Option Perspective" (2007) 32(1) Academy of Management Review 257.

[21]S. Maijoor, and A. Van Witteloostuijn, "An Empirical Test of the Resource-Based Theory: Strategic Regulation in the Dutch Audit Industry" (1996) 17(7) Strategic Management Journal 549.

[22]J. Pfeffer, and G. Salancik, *The External Control of Organizations* (Harper & Row Publishers, 1978).

[23]S. Beardsley, D. Bugrov, and L. Enriquez, "The Role of Regulation in Strategy" (2005) 4 McKinsey Quarterly 92.

[24]B. Aliouat, and C. Roquilly, "La Veille Juridique Pour une Intelligence des Situations Stratégiques" (1994) 148 Les Petites Affiches-La Loi 10 [Aliouat and Roquilly].

decision-making is involved.[25] Henisz and Zelner[26] observe that the performance of multinationals is heavily influenced by their capacity to identify risks arising from the political environment. Similarly, any legislative change can be a source of threat and so it must be detected as quickly as possible.[27] By observing social norms and their evolution, one can sometimes anticipate possible changes in the law.[28] Accordingly, legal monitoring is most efficient when changes are identified at the earliest possible stage in development. Interestingly, according to Aragon-Correa and Sharma,[29] proactive postures by a firm with respect to generating barriers to entry can imply the anticipation of regulatory trends. That being said, however, it is also important to keep in mind that the legal sphere is not homogenous. Numerous disparities still exist from one country, state or province to another. Therefore, legal monitoring in the relevant external legal environments should highlight not only what might constitute a threat but should also highlight potential opportunities. For example, certain environments offer more contractual flexibility than others. This flexibility is frequently observed in terms of the organization of corporate structures and corporate ownership.[30] Once a firm perceives its corporate structure as merely a means of organizing its resources in accordance with various objectives (involving for example, project financing, management of conflicting vested interests like entrepreneurs or investors, or the allocation of financial and legal responsibilities), the different elements of the legal sphere can then be considered organizational tools.[31] Legal monitoring can also help firms in their decision-making with regard

[25]J.A. Barrick, and B.C. Spilker, "The Relations Between Knowledge, Search Strategy and Performance in Unaided and Aided Information Search" (2003) 90(1) Organizational Behavior and Human Decision Processes 1.

[26]W.J. Henisz, and B.A. Zelner, "The Strategic Organization of Political Risks and Opportunities" (2003) 1(4) Strategic Organization 451.

[27]R. Noakes, and C. Byrne, "Corporate Governance: Corporate Culpability – How to Tackle Legal Risk" (2003) 50(1) New Zealand Management 68.

[28]R.H. McAdams, "The Origin, Development and Regulation of Norms" (1997) 96(2) Michigan Law Review 338; M.A. Eisenberg, "Corporate Law and Social Norms" (1999) 99(5) Columbia Law Review 1253.

[29]A. Aragon-Correa, and S. Sharma, "A Contingent Resource-Based View of Proactive Corporate Environmental Strategy" (2003) 28(1) Academy of Management Review 71.

[30]J.N. Gordon, "The Mandatory Structure of Corporate Law" (1989) 89(7) Columbia Law Review 1549; Gordon, "What Enron Means" (n 10); R. Romano, "Competition for Corporate Charters and the Lesson of Take-Over Statutes" (1993) 61 Fordham Law Review 843; L.E. Ribstein, "Delaware, Lawyers and Contractual Choice of Law" (1994) 19 Delaware Journal of Corporate Law 999; R. La Porta, F. Lopez-de-Silanes, A. Shleifer, and R. Vishny, "The Quality of Government" (1999) 15(1) Journal of Law, Economics and Organization 222; H. Hansmann, and R.H. Kraakman, "The Essential Role of Organizational Law" (2000) 110(3) The Yale Law Journal 387; M. Kahan, "The Demand for Corporate Law: Statutory Flexibility, Judicial Quality, or Takeover Protection" (2006) 22(2) Journal of Law, Economics and Organization 340.

[31]J. Paillusseau, "Le Droit est Aussi une Science D'Organisation" (1989) 42(1) RTDCom 9; H. Hansmann, R.H. Kraakman, and R. Squire, "Law and the Rise of the Firm" (2006) 119(5) Harvard Law Review 1333; N.R. Lamoreaux, and J.L. Rosenthal, "Entity Shielding and the Development of Business Forms: A Comparative Perspective" (2006) 119(6) Harvard Law Review Forum 238.

to the threats and opportunities that have been revealed. Capron and Chatain[32] argue that a firm's ability to scan its external environment is critical.

Regardless of whether legal considerations are ultimately characterised as threats or opportunities, legal monitoring will impact the behaviour and incentives of managers and ultimately the reaction of the firm.[33] A classification of possible reactions by the firm to legal risk should assist in revealing various strategic scenarios.

2.2.2 *Classification of Possible Reactions to Threats and Opportunities*

The different reactions to legal risk – whether viewed as positive or negative or as threat or opportunity – are evidently linked to the firm's objectives and the attitude of the decision-makers towards risk. Risk can come from a restrictive regulation that provides the market with greater security but which may also alter a firm's freedom to act as it pleases. Conversely, risk can come from a regulation that provides little security for contracts or intellectual property rights even where a firm may wish to exploit such resources.[34] Risk therefore does not manifest itself autonomously. Rather, risk is a function of a firm's objectives and, as explained below, its resources.

2.2.2.1 Reaction to Threats

The first possible reaction by a firm may be *refusal* of risk. This is where the firm accepts the constraint imposed by the legal sphere and therefore refuses to make a risky decision from a legal point of view. This submission to the rule of law might be for a number of reasons. For example, it may be that the decision-makers are particularly risk-averse and therefore decide to respect the regulation even when a failure to do so would not constitute a threat to their enterprise. In its analysis of the risk connected to a failure to respect the regulation, a firm must not only consider financial sanctions under the regulation but must also consider other factors like market pressure and the firm's environment which can add, for example, image-related risks. The development of best practices in corporate governance is an illustration of consideration for this type of image risk[35] especially in light of the

[32]L. Capron, and O. Chatain, "Acting on Competitors' Resources Through Interventions in Factor Markets and Political Markets" (2008) 33(1) Academy of Management Review 97 [Capron and Chatain].

[33]J.B. Thomas, S.M. Clark, and D.A. Gioia, "Strategic Sense Making and Organizational Performance: Linkages Among Scanning, Interpretation Action and Outcomes" (1993) 36(2) Academy of Management Journal 239.

[34]Aliouat and Roquilly (n 24).

[35]C.K. Ho, "Corporate Governance and Corporate Competitiveness: An International Analysis" (2005) 13(2) Corporate Governance: An International Review 211.

compliance programs that are being increasingly developed. Baucus and Baucus[36] demonstrate that firms which have acted illegally have lower assets on their returns than other firms. In this context, a firm might strategically decide to cancel an operation, project or configuration that is too restrictive. For example, Catalina Marketing Company specialises in behaviour based marketing and targeted advertising. In 1994, Catalina launched an electronic cross-couponing campaign for one of its clients. The mechanism was simple: when consumers bought Orangina products at a supermarket, they received a coupon for Fanta products – competing products of Orangina. The French courts considered this competitive cross-couponing as an act of unfair competition.[37] Therefore, Catalina decided to stop using this kind of marketing tool in the French territory.

The second possible firm reaction is *confrontation*. Here a firm deliberately transgresses the rule of law. A decision to confront can be explained in one of two ways: either the firm believes that to respect the regulation would carry too many constraints in relation to its activities or believes that the transgression itself poses no strategic threat and will not harm the firm's performance. In the second of these two explanations, the firm is willing to confront the rule of law because it contests the value of the regulation. This is a logical position for the firm in light of the firm's strategy which is threatened by the regulation or which sees opportunity in the repeal or modification of the regulation. French supermarket Leclerc has used this legal strategy on several occasions, in particular when challenging the French legislation on uniform pricing for fuel or on price comparison.[38]

Circumvention of the constraint is the third possible reaction by the firm. Here, the firm adopts an attitude that is neither passive nor aggressive. When its options are limited by legal restriction, the firm will look for alternative solutions within the legal sphere. For example, solutions might relate to the choice of a corporate structure and/or charters designed to better retain decision-making power.[39] Circumvention is therefore concerned with seeking out opportunity. But again, image-related risk remains a factor for consideration. A firm that avoids the impact of a labour practices regulation, for example, by seeking out a more flexible regulatory framework may experience negative repercussions in terms of public opinion.[40]

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[36]M.S. Baucus, and D.A. Baucus, "Paying the Paper: An Empirical Examination of Longer-Term Financial Consequences of Illegal Corporate Behaviour" (1997) 40(1) Academy of Management Journal 129.

[37]A. Zardkoohi, M. Pustay, C. Collard, and C. Roquilly, "Competitive Cross Couponing: A Comparison of French and U.S. Perspectives" (2001) 20(1) Journal of Policy and Marketing 64.

[38]For further discussion see Christophe Roquilly's blog on legal performance, online: Performance Juridique, http://performancejuridique.blogspot.com; See also discussion in A. Masson, "The Origin of Legal Opportunities" (2009), Chap. 3 of this text.

[39]L.A. Bebchuk, and A. Hamdani, "Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters" (2002) 11(2) The Yale Law Journal 553; P.A. Gourevitch, "The Politics of Corporate Governance Regulation" (2003) 112(7) The Yale Law Journal 1829[Gourevitch].

[40]S.J. Frenkel, and D. Scott, "Compliance, Collaboration and Codes of Labor Practice: The Adidas Connection" (2002) 45(1) California Management Review 1.

The fourth reaction a firm may have is to *modify* the constraint with the aim of either reducing the level of risk or threat or transforming the risk into an opportunity. For example, when Leclerc disrupts the income made by pharmacists through the resale of para-pharmaceutical products as part of its diversification activities, its underlying objective is to provoke a change in the legal sphere favourable to its interests.[41]

Risk *acceptance* constitutes the fifth option and generally occurs when the legal environment offers poor security and reliability. For example, the world's leading tire manufacturer, Michelin, aims to establish itself long-term on the Asian market. In 2001 Michelin signed a cooperation agreement with a Chinese company resulting in the creation of Shanghai Michelin Warrior Tire Co. Ltd. Michelin took this strategic risk despite the fact that the legal environment in China offers little security in terms of intellectual property rights and is known to have a judiciary with poor reliability. The risk became an actual threat when Michelin's Chinese partner began to manufacture and distribute tires that were counterfeit productions of those made under the joint venture.

2.2.2.2 Reaction to Opportunities

Firms will sometimes not wish to take advantage of opportunities offered by the legal sphere. This reaction may be due to risk-averse behaviour by management who fear the risks that might arise from exploitation of the opportunity.[42] It may also be due to a lack of internal resources required to convert the opportunity into a competitive advantage. Only highly successful legal monitoring will allow a firm to provoke legal opportunity within the legal sphere.

As mentioned above, a firm's actions may arise from a desire to modify a particular legal element (whether generally or from the industry or competitor environments) and transform the constraint into an opportunity. Systematic recourse to judicial procedures is one way to achieve this[43] but the primary means of generating opportunity within the legal sphere is through lobbying, sometimes referred to by certain authors as a "dilatory measure".[44] The influence that a firm can have on the behaviour of law makers is considered to be closely linked to business strategy.[45]

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[41]C. Collard, "Performance Juridique et Avantage Concurrentiel: Chronique N°2: Le Cas des Centres E. Leclerc" (2007) 146 Petites Affiches-La Loi 6.

[42]Chattopadhyay, Glick and Huber (n 13).

[43]T. Côme, and G. Rouet, *Les Strategies Juridiques des Entreprises* (Vuibert, 1997); C. Champaud, and D. Danet, *Stratégies Judiciaires des Entreprises* (Dalloz, 2006) Collection Etats de Droit, Série Regards sur la Justice.

[44]E.L. Glaeser, and A. Shleifer, "The Rise of the Regulatory State" (2003) 41(2) Journal of Economic Literature 401.

[45]D.B. Yoffie, and S. Bergenstein, "Creating Political Advantage: The Rise of the Corporate Political Entrepreneur" (1985) 28(1) California Management Review 124; B. Shaffer, "Firm-level Responses to Government Regulation: Theoretical and Research Approaches" (1995) 21(3) Journal of Management 495.

Management and legal experts with a superior understanding of the power structures behind the development of legislation have the capacity to improve the welfare of firm shareholders. It should be pointed out that it is not necessarily the content of legislation that a firm attempts to modify but rather the voting behaviour of the legislature.[46] As argued by Gourevitch,[47] the law is not an autonomous force – political power comes into play in the formative stage of the law as well as in its application and interpretation.[48] Accordingly, there is intense competition between firms for influence over the development of regulations. Certain factors can be crucial to having such influence, for example the size of the firm, its diversification and its presence internationally.[49] Further, firm intervention in political markets can also affect competitors' resources[50] and the stakes are high. As Shell points out, certain firms make the rules, while others are subjected to them.[51]

2.3 From Legal Monitoring to Sustainable Competitive Advantage: Building a Portfolio of Legal Resources and Legal Capability

Sustainable competitive advantage cannot come solely from the observation and effective management of the threats and opportunities arising from the external environment. Indeed, a firm's success in finding a sustainable competitive advantage equally depends upon its internal resources and ability to effectively mobilize them. Internal resources must therefore be aligned with external threats and opportunities.[52] A sustainable competitive advantage will be determined by the coincidence of the firm's strengths and key success factors.[53] Firms must learn to integrate the elements from the legal sphere into the development of their internal resources and legal capability.

[46]M.D. Lord, "Constituency-Based Lobbying as Corporate Political Strategy: Testing an Agency Theory Perspective" (2000) 2(3) Business and Politics 289.

[47]Gourevitch (n 39).

[48]M.J. Roe, *Political Determinants of Corporate Governance: Political Context, Corporate Impact* (Oxford University Press, 2003).

[49]F. Sadrieh, and M. Annavarjula, "Firms Specific Determinants of Corporate Lobbying Participation and Intensity" (2005) 28(1–2) International Journal of Public Administration 179.

[50]Capron and Chatain (n 32).

[51]G.R. Shell, *Make the Rules or Your Rivals Will* (Crown Business, 2004).

[52]J.B. Barney, "Firm Resources and Sustained Competitive Advantage" (1991) 17(1) Journal of Management 99 [Barney].

[53]J.A. Sousa de Vasconcellos e Sa, and D.C. Hambrick, "Key Success Factors: Test of a General Framework in the Mature Industrial-Product Sector" (1989) 104(4) Strategic Management Journal 367.

The ultimate purpose of legal monitoring is to allow firms to construct legal resources that are best adapted to their strategy and corporate projects. These resources will be included in a portfolio that is the foundation of any sustainable competitive advantage. Wernerfelt[54] sees the firm as an amalgam of resources that may serve as a point of departure for diversification while Grant[55] re-defines a firm's activities in terms of its resources. As demonstrated by the resource-based approach, which has been well analysed in the work of Métais,[56] it is the combination of resources, capabilities and core competencies that leads to a sustainable competitive advantage. It remains to be seen what role the legal dimension can play.

2.3.1 Transforming Elements from the Legal Sphere into Legal Resources

Amit and Shoemaker[57] define resources as a stock of available factors held or controlled by a firm. On the one hand, I define legal resources, as resources that generate rights (particularly property rights) and can be considered as "object" resources, i.e. contracts, corporate structures, intellectual property rights, etc. These can be viewed as "second-level" resources in that their only purpose is to protect, secure or increase the value of other types of non-legal resources by drawing on elements from within the legal sphere. This protection is ensured by the fact that the legal structure given to a firm's various resources generates enforceable rights that favour the firm. For example, the law protecting registered trademarks provides legal structure for a commercial innovation, while a patent supports a technological innovation.[58] An exclusive distribution contract provides a structure for the relationship between a manufacturer and a vendor, and a contract for partnership or cooperation does the same for the relationship between partners, whether in the case of an equity-based joint venture or a contractual partnership.[59] Finally, a firm's corporate structure organizes the relationship between the shareholders, as well as between shareholders and management, and through its articles of association, formalises a network of coherent relationships and responsibilities.

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[54]B. Wernerfelt, "A Resource-Based View of the Firm" (1984) 5(2) Strategic Management Journal 171.

[55]R.M. Grant, "The Resource-Based Theory of Competitive Advantage: Implications for Strategy Formulation" (1991) 33(3) California Management Review 114.

[56]E. Métais, *Stratégie et Ressources de L'Entreprise* (Economica, 2004) Collection Connaissance de la Gestion.

[57]Amit and Shoemaker (n 2).

[58]Cohen, Nelson and Walsh (n 9).

[59]J. Hagedoorn, and G. Duysters, "External Sources of Innovative Capabilities: The Preference for Strategic Alliances or Mergers and Acquisitions" (2002) 39(2) Journal of Management Studies 167.

On the other hand, there are legal resources that are related to the knowledge and know-how of legal experts who are used to identify certain elements in the legal sphere and generate "object" resources. As with all knowledge, these resources might be considered critical resources.[60]

This distinction between the two types of legal resources ties in with the taxonomy developed by Miller and Shansie,[61] who distinguish between resources based on property which are more valuable in a stable environment and those based on knowledge which are more valuable in an uncertain environment.

It is important for a firm to accumulate its resources. For instance, a large portfolio of patents provides a firm with a greater security cushion for protecting its innovations. As highlighted by Lanjouw and Schankermann,[62] the size of a patent portfolio makes it easier to enter into transactions without the need for legal proceedings. This accumulation allows a firm to combine its resources. Bayer, for example, combined a patent and a trademark so as to continue to generate high income even after the expiration of the patent on aspirin.[63] Similarly, by accumulating copyright and trademark protection over the same creations with respect to cartoon characters, Disney was able to diversify its legal resources portfolio and take advantage of a combination that ensures greater protection while generating major opportunity in terms of contracts on by-products. Where a real link is perceived between the management of trademarks and that of patents, in particular when mixed licensing agreements (patents, know-how, trademarks) are drawn up, coordination between a firm's trademark and patent divisions becomes crucial.

By bringing together various skills within its legal team, a firm can exploit its competencies through complex projects such as mergers and acquisitions or industrial joint ventures. The coordination of resources as made possible through accumulation, must also be achieved via the respective contributions of the legal and other experts in the firm whereby the expertise of each individual contributes to a legal resource offering the greatest protection or creation of value towards a given project or corporate action. Argyris and Mayer[64] show how it is possible to develop the best possible contracts by coordinating the know-how of a company's legal experts and engineers. Once accumulated and coordinated however, resources must not remain static.[65] The very nature of "object" legal resources is to evolve in

[60]L. Hunter, P. Beaumont, and M. Lee, "Knowledge Management Practice in the Scottish Law Firm" (2002) 12(2) Human Resource Management Journal 4.

[61]D. Miller, and J. Shansie, "The Resource-Based View of the Firm in Two Environments: The Hollywood Film Studios from 1936 to 1965" (1996) 39(13) Academy of Management Journal 519.

[62]J. Lanjouw, and M. Schankermann, "Protecting Intellectual Property Rights: Are Small Firms Handicapped?" (2004) 47(1) Journal of Law and Economics 45.

[63]M. Reitzig, "Strategic Management of Intellectual Property" (2004) 45(3) MIT Sloan Management Review 35.

[64]Argryis and Mayer (n 5).

[65]D. Leonard-Barton, "Core Capabilities and Core Rigidities: A Paradox in Product Development" (1992) 13(8) Strategic Management Journal 111.

accordance with a firm's needs and the state of its legal sphere. Indeed, the question of contractual flexibility is already well established.

This exploitation, i.e. deployment of legal resources, must be done appropriately in respect of the external environment.[66] Further, deployment must occur within the knowledge that if strategic market factors are imperfect or incomplete, barriers to the mobility of these resources might be generated.[67] It is therefore important to highlight that, legal resources, which represent opportunities taken up from the legal sphere, can themselves carry risk – they can come into conflict with the legal resources of other firms as well as with regulatory provisions. An example of this is the potential risk presented by intellectual property rights held by other firms, whether competitors or not, particularly in the domain of patents. Indeed, in the United States, the degree of uncertainty linked to the system of patent allocation is ever-increasing. The number of files to be examined is constantly on the rise (primarily due to an increase in patent requests for software programs). More than half of contested patents are held to be invalid.[68] The complexity and cumbersome nature of the procedures for registering a patent as well as the competition for innovation have created an environment that lends itself to long and costly disputes. Accordingly, the fear of ending up in the courts often leads to a settlement.[69]

The application of competition law provides another example of the risks that can be generated by the creation and deployment of legal resources. For instance, the use of intellectual property rights (patents in particular) as legal resources can alter the competition game or artificially block the entrance to a market.[70] Similarly, recourse to selective distribution contracts can result in competition law infringement if the contracts do not satisfy certain criteria, which will also likely vary from one country to the next as with the United States and EU markets.[71]

Although scholars in the fields of management and corporate strategy may suggest that legal resources have no unique features it can nonetheless be argued that "object" legal resources present two specificities. First, their construction depends inextricably on the state of the legal sphere insofar as it is the external system of norms that makes it possible to enforce their value before the courts.

[66]S.A. Lippman, and R.P. Rumelt, "A Bargaining Perspective on Resource Advantage" (2003) 24 (11) Strategic Management Journal 1069[Lippman and Rumelt].

[67]I. Dierickx, and K. Cool, "Asset Stock Accumulation and Sustainability of Competitive Advantage" (1989) 35(12) Management Science 1504.

[68]R.D. Blair, and T.F. Cotter "Intellectual Proprerty: Economic and Legal Dimensions of Rights and Remedies" (2006) 5(1) Northwestern Journal of Technology and Intellectual Property 101.

[69]A. Jaffe, and J. Lerner, *Innovation and Its Discontents: How Our Broken Patent System is Endangering Innovation and Progress and What to Do About It* (Princeton University Press, 2004); Gibson (n 9).

[70]M. Lemley, "A New Balance Between IP and Antitrust" (2007) 13 Southwestern Journal of Law and Trade in Americas 237.

[71]R. Wish "Regulation 2790/1999: The Commission's 'New Style' Block Exemption for Vertical Agreements" (2000) 37 Common Market Law Review 887; Collard and Roquilly (n 11); I. Barreda, and N. Georgantzis, "Regulating Vertical Relations in the Presence of Retailer Differentiation Costs" (2002) 22(3) International Review of Law and Economics 227.

Second, legal resources and the manner in which they are deployed have the potential to generate legal risks that will have to be balanced against the opportunities they offer a firm in terms of developing and capturing value.

2.3.2 *Combining Legal Resources and Legal Capability to Forge a Legal Core Competency*

2.3.2.1 Legal Capability: The Ability to Find the Best Adapted Legal Resources

According to the resource-based approach, capability is the second link in the chain that can lead to the creation of a sustainable competitive advantage. Amit and Shoemaker[72] define this capability as "a firm's capacity to deploy resources, usually in combination, using organizational processes, to effect a desired end". I therefore define legal capability as a firm's ability to integrate the elements from the legal sphere into the development of its legal resources by aligning them with external threats and opportunities[73] and by using them in respect of the external environment.[74] Legal capability therefore depends on processes that combine information, knowledge and know-how. An initial process must be used to gather elements from within the legal sphere and associate them with the firm's resources so as to determine whether these resources are likely to be modified, endangered or improved. This is known as Legal Risk Management. Another process should be used to request the legal resources that are best adapted to protect, develop and capture the value added by other resources of the firm. This is known as Legal Management of Risks. Legal Risk Management and Legal Management of Risks complement one another and are not mutually exclusive.[75] They are part of an overall approach to risk management and can easily be formalised using Table 2.1.

Table 2.1 Risk Management Matrix

Type of risk/ Type of risk management	Non-legal risk (NLR)	Legal risk (LR)
Legal management (LM)	Using legal resources for non-legal risks (risks from outside the legal sphere)	Using legal resources for legal risks (risks from the legal sphere)
Non-legal management (NLM)	Using non-legal resources (for instance technological resources) for non-legal risks	Using non-legal resources for legal risks

[72]Amit and Shoemaker (n 2).

[73]Barney (n 51).

[74]Lippman and Rumelt (n 66).

[75]C. Roquilly, "Performance Juridique et Avantage Concurrentiel" (2007) 86 Petites Affiches-La Loi 7.

Table 2.2 Example of Risk Management Matrix: the IPhone Case

Type of risk for Apple/ Type of risk management	Non-legal risk (NLR)	Legal risk (LR)
Legal management (LM)	NLR = development of an international gray market with unlocked iPhone	LR = class action law suit because Apple refuses to honour the warranty for unlocked iPhone
	LM = building a policy of exclusive distribution agreement, in order to sue parallel resellers for unfair competition and trademark infringement	LM = building a strong and clear contractual policy, with no warranty for unlocked iPhones
Non-legal management (NLM)	NLR = development of an international gray market with unlocked iPhone	LR = class action law suit because Apple refuses to honour the warranty for unlocked iPhone
	NLM = using technology in order to brick unlocked iPhone	NLM = no more locked iPhone, but a price discrimination whether consumers contract with the partner provider or not

In order to facilitate the reader's understanding of this table, Table 2.2 has been included as an illustration. It relates to the launch of the iPhone and in particular to the risk linked to the development of a parallel distribution network.[76]

A firm's ability to find the best adapted legal resources with which to increase the value of information and ideas (given that an idea is difficult to protect as such)[77] and organize them from a legal point of view can be measured by the firm's ability to integrate the elements that come from the external environment (keeping in mind that there are various strategies for the acquisition and protection of information).[78] A process must be in place to ensure that the adequate legal know-how is used either to create the legal resources necessary for the firm's development or to find non-legal solutions for the threats or opportunities that have come out of the external environment. The organization of a firm's legal department is very important in this respect.[79] It must not only meet the requirements in terms of legal instruments by deploying the corresponding competencies, be they internal or external, but it must also communicate and engage with the other departments within the firm, including senior management, especially where threats or opportunities are at stake.

[76]C. Roquilly, "Le cas de l'iPhone en tant qu'illustration du rôle des ressources juridiques et de la capacité juridique dans le management de l'innovation" (2009) 12(2) Management 142.

[77]A.R. Miller, "Common Law Protection for Products of the Mind: An 'Idea' Whose Time Has Come" (2006) 119(3) Harvard Law Review 703.

[78]Y. Benkler, "Intellectual Property and the Organization of Information Production" (2002) 22(1) International Review of Law and Economics 81.

[79]H. Bidaud, P. Bignon, and J.P. Cailloux, *La Fonction Juridique et L'Entreprise* (Eska, 1995).

A further process must facilitate the exchange of legal and non-legal information so as to coordinate the elements of the environment with the legal and non-legal resources. This legal capability must be dynamic. For Eisenhardt and Martin,[80] "Dynamic capabilities are the organizational and strategic routines by which firms achieve new resource configuration as markets emerge, collide, split, evolve and die". Legal routines, the processes by which legal decisions are reached, shift in accordance with the level of performance sought. Leroy Merlin, a well-known French retailer, when installing its legal intranet, allowed the store managers to manage a certain number of risks directly through simple routines, notably those linked to regulations governing pricing or promotional sales, which in turn gave the in-house lawyers greater availability to focus on questions requiring true legal expertise.[81]

2.3.2.2 The Criteria of Legal Core Competency

It is certain that all firms have legal resources at their disposal. Some of them even have legal capability. It remains to be seen, however, whether this combination of resources and capability can be said to constitute a core competency. Core competencies are generated by the resources and capabilities that allow a firm to have a sustainable competitive advantage. Firms that build strong competencies are able to make the most of strategic opportunities.[82] The transformation of resources and capabilities into core competencies requires extensive organizational learning. As alluded to earlier, resources and capabilities cannot be static, they must evolve in accordance with experience gained and collective learning[83] and it is for the firm to create the appropriate mechanisms for this learning process.[84]

It is now commonly held that four conditions must be met in order for resources and capabilities to constitute core competencies and thereby lead to a sustainable competitive advantage. They must be valuable, rare, inimitable or costly to imitate and non-substitutable.[85] One might ask whether legal capability, when linked to certain legal resources, can produce a core competency. If a valuable capability is one that allows a firm to seize opportunities and neutralise threats coming from the

[80]K. Eisenhardt, and J.A. Martin, "Dynamic Capabilities: What are They?" (2000) 21(10–11) Strategic Management Journal 1105.

[81]C. Roquilly, and P. Malfoy, "La Mise en Place D'une Veille Juridique Informatisée: Le Cas de Leroy Merlin", D. Bourcier, P. Hassett, and C. Roquilly ed., *Droit et Intelligence Artificielle, Une Révolution de la Connaissance Juridique* (Romillat, 2000) 168.

[82]D. Lei, M.A. Hitt, and R. Bettis, "Dynamic Core Competences Through Meta-Learning and Strategic Context" (1996) 22(4) Journal of Management 549.

[83]C.K. Prahalad, and G. Hamel, "The Core Competence of the Corporation" (1990) 68(3) Harvard Business Review 79.

[84]S. Ghoshal, "Global Strategy: An Organizing Framework" (1987) 8(5) Strategic Management Journal 425.

[85]Barney (n 52).

external environment, then legal capability satisfies this condition. A rare capability is more difficult to observe insofar as it requires knowledge of a competitor's resources and capabilities. Hence, with regard to the rarity of legal capability, a firm must therefore identify for each competitor, the presence of a legal monitoring system, the size and quality of their legal resources portfolio and the processes that lead to their legal decision-making.

The recognition of a core competency also requires capabilities that are costly to imitate. The difficulty in imitating legal capability can be explained by what Nanda calls causal ambiguity.[86] Reed and De Filippi[87] cite three factors of causal ambiguity: complexity, specificity and tacitness. In terms of the application of these three factors to legal core competency, it is not the legal resources that are complex nor is it the knowledge or know-how of a firm's legal experts. Rather, complexity may be found in the relationship between the legal experts and the other members of the firm as well as the processes that lead to legal decision-making, i.e. the ongoing creation of legal resources. Specificity is to be found in the fact that legal resources are only relevant if they contribute to the legal organization of the other types of resources in respect of the threats and opportunities coming from the environment. The choice of licensing policy for patents, or the adaptability of distribution contracts to the market characteristics and the type of products concerned, or the contractual relationships between shareholders are all examples of things that must be kept specific to an individual firm. The notion of tacitness implies that legal capability has an informal dimension. The more this informality is pronounced, the greater the difficulty to imitate the capability.

Finally, legal capability must be non-substitutable. The more a capability is difficult to identify, the more it will be difficult for a competitor to find a strategic equivalent. According to Barney,[88] a competitive advantage is developed in the short term when a firm's resources and capabilities are valuable and rare. The advantage becomes sustainable when they are inimitable and non-substitutable.

There is no doubt that legal capability constitutes a network of assets, knowledge and know-how that is woven from among the resources themselves and the individuals within a firm and for which it is difficult to find a substitute. There is nonetheless a type of paradox that seems inherent to the very notion of core competency. Sirmon, Hitt and Ireland[89] explain that in order to reduce the inherent complexity of the external environment, firms codify as much knowledge as possible in the form of organizational routines. Tacit knowledge is therefore a determining factor: the more tacit knowledge is, the more difficult it will be to

[86]A. Nanda, "Resources, Capabilities and Competencies" (1993) Working Paper No. 94-035 Harvard Business School.

[87]R. Reed, and R.J. De Filippi, "Causal Ambiguity, Barriers to Imitation and Sustainable Competitive Advantage" (1990) 15(1) Academy of Management Review 88.

[88]Barney (n 52).

[89]D.G. Sirmon, M.A. Hitt, and R.D. Ireland, "Managing Firm Resources in Dynamic Environments to Create Value: Looking Inside the Black Box" (2007) 32(1) Academy of Management Review 273.

imitate and substitute. How, then, does one codify what must remain tacit? Legal capability, as described above, must draw on routines and organizational processes that can only be effective if they are codified. By contrast, the creation within a firm of a true legal culture – a sort of alchemy that makes a lasting mark on a firm's "genetic" code – can only be tacit. Corporate culture, or organizational culture, can be a strategic asset for a firm.[90] Without categorically stating that a firm's legal culture can be a strategic asset, one might nonetheless argue that it is incorporated in the firm's corporate culture. The more legal experts are perceived as creators of resources and as holding the potential to improve a firm's performance, the more a firm's legal culture will be an integral part of its corporate culture.

2.4 Conclusion

Although not unfamiliar to academic scholars in strategic management, the importance of the legal dimension in strategic decision-making has yet to be sufficiently explored. Progress in formalising the strategic role of the law and legal decision-making for a company involves the recognition of the legal sphere as a source of both threats and opportunities, the interaction between the legal sphere, legal resources and legal capability, as well as the identification of a legal core competency, which can be a source of sustainable competitive advantage or at minimum, contribute to the creation of such an advantage. It is argued herein that this competency corresponds to the emergence of a new concept – that of Legal Performance. Legal Performance relates to the ability of a firm to develop a legal core competency.

That being said, the scope of this paper is nonetheless limited. Beyond a theoretical framework, it is vital to research the existence (or non-existence) of legal core competency. Future research should be dedicated to study how legal monitoring allows a firm to better anticipate or better shape legal changes particularly when changes constitute threats or opportunities. Future research should also seek to determine how the reactions of a firms impact on their respective performances.

Another avenue of interest might be to investigate the relationships and combinations between legal and non-legal resources, the value created by legal resources and their intangible and combined characteristics. Obviously, the recognition of a legal core competency merits further development and attention, particularly with respect to the role of legal culture within a firm. Moreover, how should the level of legal performance within a firm be measured? Should a firm's performance be analysed first, before considering the contribution made to this performance by the legal (core) competency or should an analysis of a firm's resources and legal

[90]J.B. Sorensen, "The Strength of Corporate Culture and the Reliability of Firm Performance" (2002) 47(1) Administrative Science Quarterly 70.

capabilities precede an evaluation of the correspondence between the level of its resources and its performance? These questions offer some of the intellectual groundwork required that may contribute to an improved integration of legal parameters into our understanding of strategic management.

Chapter 3
The Origin of Legal Opportunities

Antoine Masson

Abstract This chapter sets out to determine the origin of legal strategies by attempting to include and/or identify the possible resources that might be mobilized in the realisation of a legal strategy. Following this line of attack, the chapter first looks at the potential sources of legal strategies by identifying the legal opportunities that arise out of the misuse of norms. The chapter then shifts its focus to responses and examines the difficulties encountered by a given legal system in fully addressing legal strategies in action.

3.1 Introduction

The concept of "legal strategies" as typically employed by legal practitioners is rarely analysed. In the academic field, the expression has been mainly used in the judicial context, i.e. in research regarding the best strategy for winning lawsuits. Thereafter, a few authors applying management methods – particularly the resource approach – have considered legal strategies that result from the firm's mobilization of the legal resources offered by its environment in order to achieve business objective(s).

However, beyond the managerial analysis, a second approach can be developed in order to analyse the origins of legal strategies and how they are made possible – as opposed to simply assessing how firms use Law.

Far from conflicting, these two approaches complement each other: the managerial approach is aimed at determining which legal choices are the most efficient to improve the performance of the firm and the normative approach is aimed at

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improving the comprehension of the origin of legal strategies in order to detect the existing legal opportunities.

Following the normative approach, this chapter first looks at the potential sources of legal strategies by identifying the legal opportunities that arise out of the misuse of norms. The chapter then shifts its focus to responses and examines the difficulties encountered by any given legal system in fully addressing legal strategies in action.

3.2 The Imperfection of Norms as a Source of Legal Opportunities

In order to implement legal strategies, companies have potential recourse to two types of legal resources, namely, rules that purposely provide room for firms to act and resources that are derived from the misuse of legal instruments or norms.

With respect to the latter, in order to prevent a misuse of Law, each norm should possess the following characteristics:

1. impersonal, general and timeless;
2. clear, comprehensible, realist and considered as known to all;
3. consistent with the other existing legal norms; and
4. intangible and receiving of predictable application.

These characteristics however rarely ring true, due to the societal and political nature of Law. Accordingly, these characteristics will necessarily change to adapt themselves to socio-economic evolution. For example, the adoption of a hurried reform by a legislator under popular pressure can alter the clarity of a law or even its application in that certain reforms are often unknown to the agents in charge of their application. In the same way, too much legislative activity can compromise the consistency of the law because of limits to available resources, at the very least in terms of time, to create norms.

The result of all this, is the existence or creation of opportunity that can be mobilized by firms to implement their legal strategies. These opportunities can be classified, according to their nature, into the following four categories, "soft" law, "hazy" law, "crazy" law, and "flexible" law – each acting as a source for different legal strategies and thus providing the basis for a legal strategies typology (Table 3.1).[1]

[1]The meanings given to each of these expressions in this article are different from those generally admitted. See M. Delmas-Marty, *Le Flou du Droit*, (Presses Universitaires de France, 1986), and (Quadrige, 2004). See also M. Delmas-Marty, *Towards a Truly Common Law: Europe as a Laboratory for Legal Pluralism*, translation by N. Norberg, (CUP, 2002) 168.

3.2.1 Soft Law

While norms should be impersonal, intangible, and general and organized according to a hierarchical system of intangible value,[2] norms can be substantively created or modified in order to serve a particular interest. For example, the development of lobbying strategies by firms to frame the legislative environment in their favour.

3.2.2 Hazy Law

Notwithstanding that norms are supposed to be comprehensible, based on objective criteria, and known to all, a firm's normative environment is riddled with legal voids, either real or perceived, due to the legal actors' absence of knowledge. Indeed, a jurist will necessarily and frequently resort to the simplification of abstractions. For example, competition law, despite apparently containing general principles such as prohibition of anti-competitive collusion, relies at the end of the day on a network of case-law adopted in specific situations and in the light of complex economic considerations. Consequently, the necessary simplifications resulting from an overly economic approach, for example, can lead to certain difficulties in predicting outcomes in this field.[3]

As a result of this lack of clear guidance on applicable substantive or procedural laws, strategies of optimisation arise.[4] One example in competition law is the haziness surrounding the definition of the "market share" notion. Consequently, the definition of this concept within a specific case is frequently the object of in-depth discussions between companies and the administration with such difficulties leading to the giving up of market share threshold.

3.2.3 Crazy Law

Despite the fact that norms are supposed to be organized according to a certain coherence, contradictions in norms often occur without any tools available to

[2]Each norm is supposed to protect an interest considered as relevant for the entire nation.

[3]In this category we also find strategies based on the incompleteness of contracts. More precisely, if the strategies linked to the drafting of contracts rely on flexible law, the strategies often linked to the difficulty in enforcing certain contracts relate to "hazy law" or perhaps "crazy law" when one of the parties voluntarily adds a provision to neutralise the effect of another.

[4]In the situation of legal optimisation through a void in the applicable procedural law, a company will use the haziness of a concept to intimidate an opponent, because businesses, under threat of judicial proceedings, will tend to change their conduct, whether the proceedings are justified or not, in order to not be the object of criticism.

clearly resolve them. For example, contradictions can result from regulatory competition at the international level or from internal legal pluralism. These contradictions between norms can be used for optimisation strategies through a process of "filling-up". Strategies that play on the overlapping of norms rely on, for example, situations where: a legislator permits the strategist to choose between several legal regimes;[5] several branches of law are applicable (for example the coordination between competition and intellectual property law); or several legal orders overlap – for example the ability to choose the application of European or Federal law to avoid the application of national law.[6]

3.2.4 Flexible Law

Norms are often not applied as they should be or their application produces effects other than those that can be predicted by the law because of additional legal problems. Examples of these situations are various and range, for example, from the non-prosecution of certain copyright infringements on the internet to the media impact on the filing of criminal complaints. Due to the potential wide-range, three types of legal strategies based on flexible law can nonetheless be identified.

The first one is based on risk assessment. The divergence from the idea that norms are expected to be objective with predictable application, i.e. the realist nature of law, makes it possible for firms to employ risk calculation in order to determine if they should comply with a specific norm. Indeed, resisting unfairly to a legitimate demand from a supplier can constitute a simple strategy when, for example: foreclosure rules apply; the cost of undertaking a legal action will be higher than not taking action; or when a firm can rely on plaintiff weariness. For example, in debt collection procedures, frequently, the debtor will not show up in court and may also refuse to pay in order to gain time.

The second type includes all forms of abusive legal action that use the litigation process as a way to pressure the competition. Indeed, due to the uncertainty of judicial outcome or because litigation could damage company reputation, some

[5]For example, to avoid the applicability of the law on collusion, a company will prefer to internalise its costs by absorbing its rivals. Accordingly, the risk will then fall within the scope of the merger control regime. However, because the test used here is much hazier than the one used under the law on collusion, the company will benefit from flexibility. In this way, the origin of legal resources, as they are understood by certain authors in the field of management, is to be found in crazy law. See C. Roquilly, "From Legal Monitoring to Legal Core Competency: How to Integrate the Legal Dimension into Strategic Management" (2009), Chap. 2 of this text.

[6]For example the acquisition of AEG-Kabel (Germany) by Alcatel (France) was authorised by the European Commission for Competition Law when the German competition authority was opposed to it.

Table 3.1 Four categories of opportunities as sources for legal strategies

Desirable characteristics of law	Categories of opportunities	Examples of resulting strategies
Impersonal, general and organized according to a hierarchical system of intangible values	*Soft law*	Lobbying
Comprehensible, based on objective criteria, considered to be known to all	*Hazy law*	1. Legal optimisation through the void in applicable substantive law 2. Legal optimisation through the void in applicable procedural law
Consistent character of a norm	*Crazy law*	Optimisation through "filling-up"
Objective, intangible, and predictable application (realist nature of law)	*Flexible law*	Management of legal margins

firms fear litigation and consequently would prefer to accept a deal or settlement in their disfavour instead of struggling to assert their rights.

The third type is related to the inadequacy of certain remedies. For example, the French supermarket Leclerc, made it their specialty to litigate various statutes, including those that sought to regulate the sale price of gasoline in France during the 1980s and developed their activities accordingly. Indeed, the company was able to profit not only from the advantage of being the first to apply low prices in this sector – the strategy of domination by prices – but has also profited from developing the public image of a militant company fighting on behalf of consumers. Recently, the Leclerc stores launched a website to compare its prices with those of its competitors. The latter immediately brought an action against Leclerc accusing it of using unfair criteria for comparison on the basis that the criteria were not relevant, objective or verifiable. The commercial court of Paris gave a judgment ordering Leclerc to close its web site but the company persevered and launched a second version of its website. Competitors litigated again but this time the commercial court found that the criteria used by Leclerc was relevant and therefore rejected the competitors' claim.

According to Christophe Roquilly,[7] Leclerc drew benefits from the media impact generated by the case which was more profitable for the firm than if the claim was dismissed. Indeed, the first web site created a public event, the media lawsuit increased the firm's public image, and the polemical decision contributed to establish the reputation of a firm defending its freedom of expression.

[7]For further discussion see Christophe Roquilly's blog on legal performance, online: Performance Juridique http://performancejuridique.blogspot.com; See also C. Collard, "Performance Juridique et Avantage Concurrentiel: Chronique N°2 : le Cas des Centres E. Leclercs" (2007) 146, Petites Affiches-La Loi 6.

3.2.5 *Dual Strategies*

It is interesting to note that beside these "first generation strategies" exist "second generation strategies" that combine one of the characteristics of law, considered positively, with the opportunities as described above. Although they appear to be more risky, they can also prove to be more effective. One example would be to first enter into collusion with rivals and then denounce this collusion to the authorities in order to benefit from their clemency while the rivals receive heavy sanctions. This situation, if it ever arose, would imply the creation of a legal situation in order to reap a benefit from it.[8] It therefore relies on the possibility of qualification (hazy law) but perhaps more so, relies on the objective and predictable character of the legal norm itself.[9]

[8]"Strategies are fond of reverse causality". S. Woog, La Stratégie du Créancier, (Dalloz, 1997). In this situation, the elaboration of the strategy starts from the objective to be reached and goes back to the cause of the norm that will be referred to. This approach relies on the rule that the facts determine judicial outcomes.

[9]Another classification can be elaborated based on the chronological articulation of strategies:

(a) Ex ante strategies: First of all, certain strategies are situated uphill from the use to be made of a norm. The modeling of a favourable legal environment will then be the objective of the strategy (soft law). In order to achieve this, companies resort to lobbying, demand for consultations, commission scientific articles or achieve judicial militancy before tribunals (through the use of "test cases"). In this way, the company can try to place the law in line with its own practices or force rivals to respect the content of the law.

(b) Intermediate strategies: Certain strategies appear after the creation of the norm but before the appearance of a dispute. The company must manage its legal environment in order to profit from the legal opportunities that might arise (mostly by using hazy and crazy law).

(c) Ex post strategies: Finally, the utilisation of the courts can have a destabilising effect on certain rivals (mostly through the use of flexible law and sometimes hazy procedural law). This strategy relies on the absence of knowledge of the norm by the rival, and on the imbalances in legal resources. However, a judge in certain situations may be able to compensate for the inadequacies of one of the parties and thereby limit the chances of success of such a strategy.

A further classification might be drawn according to who will be a respondent. Some strategies will aim at attaining a specific legal statute which gives a comparative advantage to their author. Such strategies generally occurring in the context of public law will place a firm in opposition to a representative of the government or at least the public interest. These situations will be referred to as vertical strategies. However, when the strategies used are directly targeted at damaging a competitor, the term horizontal strategies might be employed.

3.3 Difficulties for Legislators in Responding to Legal Strategies

Any legal system confronted with a firm's attempt to exploit legal opportunities will look to its own resources to assist in its prevention. In the same way that there is diversity in strategies employed by firms there is also considerable diversity in the possible answers or responses to them. Further, the creation or adoption of effective answers to legal strategies is very difficult as legal systems are faced with, at minimum, three possible hurdles to respond to legal strategies efficiently: first, regulators are frequently bound by external constraints; second, regulators follow their own strategies which either converge or diverge from those of the company; and third, the responses brought by regulators may have a paradoxical effect in that they can reduce the effectiveness of certain strategies while increasing the effect of others.

3.3.1 Constraints on the Actions of Regulators

Regulators can be faced with constraints that limit their recourse in the adoption of efficient legal instruments.

First, resource constraints make it rarely optimal to completely dissuade strategies because the potential cost in doing so can be exponential. In this respect, the development of private enforcement mechanisms rather than public enforcement mechanisms are often encouraged because they allow for the transfer of certain costs, for example, investigation costs, to private actors.

Second, dependency on certain institutional paths or political pressure can delineate the choices available which in turn can also increase the probability of crazy law.[10]

Third, regulators are often faced with difficulties in accessing the relevant information necessary to the successful achievement of their goals.[11] To solve this problem, regulators must make choices in the allocation of resources with respect to phases of monitoring, investigation or procedure. For example, regulators might allocate more resources to increase crime detection.[12] A further possibility that does not require recourse to additional resources is to increase the level or amount of a sanction and then rely on the deterrent effect thus produced. As alluded

[10]For example, the importance given to the transparency of public actions can make the use of alternative modes of dispute resolution politically complicated for regulators, because these modes are often secretive.

[11]The increasing use of economic analysis has largely contributed to this problem because it requires access to a considerable amount of information as well as up-to-date data.

[12]See P.G. Bryant and E.W. Eckard, "Pricing: the Probability of Getting Caught", (1991) 73(3) Review of Economics and Statistics 531–536; J.M. Connor, "Price-Fixing Overcharges: Legal and Economic Evidence", (2004) Purdue University Staff Paper 04-17.

to above, the level or amount of a sanction can play a coercive role and at the same time can push companies to reveal their information thereby increasing the effectiveness of regulation.[13] Similarly, leniency, whistle-blowing or self-incrimination can assist the regulators' mission and save public money. However, these mechanisms can also produce paradoxical effects. For example, while leniency programs certainly reduce the cost of investigation they also reduce the rate of dissuasion as companies know that they will be able to reduce their sanction(s) by relying on such a program if they are found out. These tools can even produce pro-collusive effects. For example, leniency can be used as a threat by members of a cartel against a company that would like to depart from their agreement.[14]

Fourth, regulators and companies also compete in the recruitment of the most qualified people. This "expertise" competition has sometimes been resolved by a company making some of its personnel available to regulators, thus increasing the risk of capture.

The constraints faced by regulators as described above, not only limit the possibility for regulators to prevent legal strategies, but often lead to new legal strategies. For example, consultations and advisory opinions allow regulators to gather information on the economic and regulatory difficulties faced by companies, but also allow companies to build up a network of legal opinions which they will be able to use, in due course, as a legal shield.[15]

3.3.2 Interaction Between the Strategies of Regulators and the Strategies of Companies

Legal systems vary in their mode of response to legal strategies as no perfect response to all possible strategies exists.[16] Hence, regulators must try to put a

[13]These mechanisms are all the more interesting if they occur during the monitoring phase and not the investigation. Consequently, regulators will be more lenient if a company denounces an anti-competitive behaviour as soon as possible.

[14]In such a case, others members of the cartel could expose the agreement before the deviant firm and rely on leniency programs in such a way that only the deviant firm will be penalised. Whistle blowing can also produce perverse effects when it is remunerated. Indeed, a manager could be interested in the adoption of anti-competitive behaviour by the companies that have hired him only to denounce the behaviour later and as it is often difficult to identify the initiators of a decision, the manager can pocket the premium.

[15]A. Masson, "La Doctrine du Régulateur", (June 2006) Bulletin Joly Bourse. Regulators are bound by their own opinion according to EU Law. See *P. Dansk Rorindustri and others* v. *Commission (Pre-Insulated Pipes Cartel)*, [2005] ECR I-5425 ECJ, ECJ case C-189, 202, 205, 208, 213/02.

[16]Perhaps the most widely known response which is present in many legal systems is what is sometimes referred to as the doctrine of abuse of rights or abusive use of rights. The doctrine of abuse of rights relies on the idea that an individual may exercise his/her right in a such abusive way that he/she should be deprived from relying upon it, for example when the right is exercised solely

balance or "policy mix" in place that seems most appropriate both in light of the existing risks that they have detected and in light of their own objectives, underscoring that regulators, like all legal actors, pursue their own objectives. Regulator objectives can be ideological, doctrinal, economic or simply aimed at ensuring their own survival. Consequently, regulator objectives or strategies can interact with those of the firms' and assist firms in the development of new legal strategies. Examples are numerous and varied.

As a first example, a regulator following an ideological objective can introduce a vertical private enforcement mechanism in competition law to promote consumer support for the virtues of liberalism by allowing the consumer to draw a direct benefit from competition law. The ideological strategy followed by the regulator will indirectly confer new opportunities for firms to destabilise their competitors, for example through the financing of a consumer class-action suit against a rival firm.[17]

Second, doctrinal and conflicting conceptions can lead some regulators to opt for high levels of sanctions and low levels of surveillance while other regulators will prefer to take the opposite route. At a European level, these choices tend to differ from one country to another, even within harmonised fields.[18] Further, the level of resources given to each national regulator will vary according to each Member states' political priorities. Even when there is efficiency at the national level, such a difference can lead to legal opportunities like forum shopping – even in harmonised fields – based on choice of jurisdiction known for a laissez-faire approach.

Third, some countries do not regulate certain activities in the hopes of benefiting from positive externalities which arise as a consequence of the strict regulatory policies applied by other countries. This form of regulatory competition will again facilitate law shopping strategies.

Last, if the harmonisation of existing legal rules between geographical areas is a good solution to avoid forum shopping, it necessarily implies the disappearance of diversity in legal systems and consequently a reduced autonomy for national regulators. In the same way, the harmonisation or the inter-regulation of various legal orders existing within the same legal system can lead to the disappearance of sector regulations, or, in the case of inter-regulation, to their subordination to a meta-regulator. Therefore, certain regulators, particularly in cases of sector regulation, might be tempted to adopt conduct aimed at justifying their continued

to harm another or to avoid legal duties. Put another way, the doctrine of abuse of rights is a principle that the unreasonable, abusive, or malicious exercise of a right can be grounds for liability. Therefore this doctrine is also sometimes referred to or recognised as "Abus de droit", Equity (as Equity was developed to prevent the abusive exercise of common law rights), abuse of litigation, law defamation, contempt of court, or any anti-law scheme or avoidance instrument. For further discussion on the doctrine see for example, M.S. Amos, "Abusive Exercise of Rights According to French Law" 2(3) Journal of the Society of Comparative Legislation 453.

[17]Thomson S.A., for example, is said to have initiated, between 1993 and 1996, a destabilisation strategy against Matra through a class action suit. See J. Follorou, "Taiwan: Thomson-CSF Aurait Bien Tenté de Déstabiliser Matra Entre 1993 et 1996", (June 30, 2001) Le Monde.

[18]Harmonisation encourages forum shopping by facilitating legal system benchmarking.

independent existence and may especially rely on market players to enhance their legitimacy and as a consequence will develop soft law.

However, even if regulator strategies can lead to legal opportunities, legal strategies adopted by companies do not always have a negative impact on regulators. Indeed, legal strategies force companies to be careful about their activities, which in turn will reduce the potential costs of control for regulators.[19] Similarly, *ex ante* legal strategies can end up in front of a judge which may allow for the clarification of hazy concepts and thus limit *ex post* strategies. Additionally, legal strategies can stimulate legal innovation by the regulator. Finally, legal strategies can serve to reinforce the regulator's role as a referral body – and thus its legitimacy – when they play with the lack of clarity of the rules or the other party's perception of the role of the regulator.

3.3.3 Some Paradoxical Effects of Regulator Responses

Generally speaking, there are two typical responses to legal strategies. Both responses are not only insufficient but they can also be seen to produce paradoxical effects.

The first typical response is the reinforcement of the legislative framework by making it more complex and detailed in order to cover all existing possibilities for bypassing the legal rule. Conversely, the second response typically involves a simplification of the rules leaving it to the judge to have an actual appreciation of the principles. Both approaches, however, lead to unsatisfactory results. We have already reviewed how the latter approach can lead to the creation of new strategic opportunities above. As for the first approach, the increasing complexity of law increases the risk of legal overlapping and thus "crazy" law. Given the outcomes, one can question both approaches. On the one hand, in extreme situations, the reinforcement of the legal framework produces flexibility because of the accumulation of rules. On the other hand, the simplification of the legal framework is compensated by a multiplication of judge-made rules particularly those aimed at maintaining a balance between parties or strengthening procedural rights, which leads to a strengthening of law. It thus becomes apparent from these considerations that irrespective of political constraints, regulators do not have the perfect response to all possible strategies.

Moreover, the responses to legal strategies offered by a given legal system can sometimes contradict each other. Take for example the practice of "private enforcement" in competition law. Until recently, European Law had mostly insisted on horizontal private enforcement, i.e. as between competitors, as opposed to vertical private enforcement between customers and firms, through the creation of

[19]For further discussion, see A. Masson, "Private Enforcement Vertical et Private Enforcement Horizontal", (May 2006) Revue Lamy Droit de la Concurrence 79.

clemency measures which allow a company, despite its being guilty of a competition law breach, to exonerate itself of its responsibility by giving up the co-authors of the breach.[20] The idea was to create an atmosphere of distrust among businesses in order to prevent them from breaching certain rules. The current approach by the European Union however is to create a mechanism based on vertical private enforcement whereby consumers act to obtain reparations for the damage suffered. However, these two modes of enforcement (horizontal and vertical private enforcement) have conflicting logics. Indeed, consumers who have suffered damage from a breach of competition law will be given a right to obtain reparation. Clearly, this is not compatible with the leniency measures allowing a company to exonerate itself from its responsibility. In the same way, if legal uncertainty can constitute a goal for the regulator (for example, uncertainty can broaden the potential scope of application of a rule or at least, the perception that companies will have of its scope[21] and can also provide a judge with more flexibility in applying a norm to a complex situation) it can also favour strategies of legal optimisation as well as horizontal judicial strategies between businesses.

Additionally, certain solutions aimed at vertical strategies can in fact produce new horizontal strategies. For example, in order to fight against strategies of cost-effectiveness calculations, some systems will resort to punitive damages which in turn will favour procedural destabilisation strategies. The question of a forced sale of assets – as a remedy to a breach of competition law for example – is a good example of a response to a strategy which can serve to produce other strategies. Similarly, "spotlight regulation", whereby regulators make certain regulatory decisions public in order to draw the attention of other businesses to the risks of certain questionable activities, can also lead to the promotion of other horizontal strategies. Indeed, for companies with limited access to legal resources, this type of regulation can create unjustified distrust towards the regulator. Further, it will be difficult for these companies to have a clear understanding or knowledge of what constitutes conduct that will be in conformity with the prescribed rules. It follows then that these companies can be more easily destabilised by, for example, the mere threat of litigation.

The paradoxical effect of some responding mechanisms to legal strategies is not always undesirable. Indeed, to gain in efficiency, some of these mechanisms have themselves developed their own imperfections. Perhaps the best example of this is the doctrine of abuse of rights,[22] the scope of which is purposely kept uncertain. For example, if the French *Cour de Cassation*[23] has concluded that liability will follow when the exercise of a right carries with it an intention of harm, bad faith or fraud,

[20]Official Journal of the European Union, "Commission Notice on Immunity from Fines and Reduction of Fines in Cartel Cases" (2006) C 298/11, 17.

[21]It is interesting to see that in its nuclear policy, France for example, purposely maintains uncertainty on what attacks can call for a nuclear response.

[22]See (n 16).

[23]The Court of Cassation is the highest court of the French judiciary.

the precise definition of each situation that will result in liability remains unclear. Indeed, the efficiency of such doctrine is founded on its capacity to be used when a person has relied on the precise definition of some legal instrument to produce an effect which was not intended or expected by the legislator.

In other situations, opportunities are voluntarily introduced in order to encourage the use of certain legal strategies by firms either to allow them to respond to legal strategies – for example the institutionalisation of lobbying facilitates the possibility for small firms to have access to political decision makers and thus defend their position against larger firms – or because some legal strategies are viewed as having positive attributes or effects. Indeed, all legal strategies do not necessarily conflict with the general interest. Some strategies can lead to the correction of normative errors or to fill in legal gaps. For example, the militancy demonstrated by certain applicants to the European Court of Justice has accelerated the adaptation of the national law to the requirements of Community legislation and is often the origin of the most important European cases.[24] For these reasons, rather than fighting legal strategies on a case by case basis, it is likely more efficient for regulators to re-orientate existing practices towards institutionalised forms of action. For example, in the European Union, the game of influence between decision makers and firms has been re-orientated towards more institutionalised forms of lobbying which can be better regulated. However, this reorientation of firms' behaviors does not prevent all legal strategies. At best, it forces their reliance on the mobilization of legal resources voluntarily created by the Law-makers instead of misusing certain norms. Consequently, whatever form the policy mix takes, legal opportunities will not disappear, only the nature of these opportunities will change (Table 3.2).

Table 3.2 Limits of legal strategies

Categories of opportunities	Strategic opportunity used	Examples of limits
Soft law	Normative shaping	Hierarchy of norms, pre-existing norms and more specifically what Hart[a] calls "secondary norms"
	Strategies based on agreements	Scope of application of the public order concept; statutory instruments
Hazy law	Optimisation through void in substantive or procedural law	Existing case-law/precedents
Crazy law	Filling-up optimisation	Law on conflict of rules (hierarchy of norms; proportionality)
	Exit option	Extra-territorial effect of norms
Flexible law	Margin management	Coordination between private and public enforcement
	Procedural strategy	Abuse of process

[a]H.L.A. Hart, *The Concept of Law* (Clarendon Press, 1994)

[24]A. Masson, and C. Micheau, "The Werner Mangold Case: An Example of Legal Militancy", (2007) 13(4) E.P.L. 587.

3.4 Conclusion

From the dichotomy between what norms should be, and what they are, emerge legal strategies. The desired theoretical characteristics of legal norms are imperfectly captured in real statutory instruments which in turn require legal fictions to realise the essential functions of the legal norms. These fictions produce coercive and concrete effects in spite of their nature and can be overturned or used abusively by a firm – as illustrated above – in order to create or obtain economic advantage over its competitors.

Despite that the effects of legal strategies can be reduced by regulators through their selection and application of the best combination of legal mechanisms, these regulatory responses are necessarily imperfect, often becoming a source for new strategies.

The result of the constant and essential interaction between legal strategies and regulatory responses is the persistence of legal opportunities.

Chapter 4
A Theory of Legal Strategy*

Lynn M. LoPucki and Walter O. Weyrauch

Abstract By the conventional view, case outcomes are largely the product of courts' application of law to facts. Even when courts do not generate outcomes in this manner, prevailing legal theory casts them as the arbiters of those outcomes. In a competing strategic view, lawyers and parties construct legal outcomes in what amounts to a contest of skill. Though the latter view better explains the process, no theory has yet been propounded as to how lawyers can replace judges as arbiters. This chapter propounds such a theory. It classifies legal strategies into three types: those that require willing acceptance by judges, those that constrain the actions of judges, and those that entirely deprive judges of control.

Strategies that depend upon the persuasion of judges are explained through a conception of law in which cases and statutes are almost wholly indeterminate and strategists infuse meaning into these empty rules in the process of argumentation. That meaning derives from social norms, patterns of outcomes, local practices and understandings, informal rules of factual inference, systems imperatives, community expectations, and so-called public policies. Constraint strategies operate through case selection, record making, legal planning, or media pressure. Strategists deprive judges of control by forum shopping, by preventing cases from reaching decision, or by causing them to be decided on issues other than the merits. The theory presented explains how superior lawyering can determine outcomes, why local legal cultures exist, how resources confer advantage in litigation, and one of the means by which law evolves.

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4.1 Introduction

> If the judges say a contract with your buyer that he will not resell below a certain price will be illegal, and not enforceable, if they are likely to fine you or send you to jail for making such a contract, but you still want your goods resold throughout the country at a single price-what can you do? That is a problem for invention, for ingenuity; the problem of inventing a method of action which will keep you free of difficulty and will produce the results you want in spite, if you please, of what the judges in a case of dispute may be expected to do. Karl N. Llewellyn[1]

In the conventional view of the legal process, courts determine facts and then apply law to those facts to generate outcomes.[2] In the strict, formalist version of the conventional view, the law consists principally of rules in which the outcomes of cases are already implicit.[3] In the more popular version, the law is a mix of fixed rules and flexible standards that sometimes permit courts to inquire into purpose and to exercise judgment and discretion.[4] In either version, the conventional view holds written law to be an important determinant of legal outcomes. To the extent that the

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[1]K.N. Llewellyn, *The Bramble Bush: On Our Law and Its Study* (Oceana Publications, 1960) 14 [Llewellyn, *The Bramble Bush*]. Llewellyn's reference was to statutes banning resale price maintenance contracts. In those contracts, retailers agreed not to sell the manufacturers product for a price less than that specified in the contract.

[2]The conventional view is typically described in terms such as these: "The common-law decisional process starts with the finding of facts in a dispute by a fact-finder, be it a jury, judge, or administrative agency. Once the facts are ascertained, the court compares them with fact patterns from previous cases and decides if there is sufficient similarity to warrant applying the rule of an earlier case to the facts of the present one." R.J. Aldisert, *Logic For Lawyers: A Guide to Clear Legal Thinking* (Contemporary Medical Education, 1992) 2–4; The breadth of acceptance of the conventional view is illustrated in Marc Galanter's classic article on why the "haves" come out ahead. Although Professor Galanter ultimately argues for a partially strategic explanation of case outcomes, he begins by starkly assuming the conventional view as a frame of reference: "This society has a legal system in which a wide range of disputes and conflicts are settled by court-like agencies which purport to apply pre-existing general norms impartially (that is, unaffected by the identity of the parties) … The rules applied by the courts are in part worked out in the process of adjudication (courts devise interstitial rules, combine diverse rules, and apply old rules to new situations). There is a living tradition of such rule-work and a system of communication such that the outcomes in some of the adjudicated cases affect the outcome in classes of future adjudicated cases." M. Galanter, "Why the 'Haves' Come Out Ahead: Speculations on the Limits of Legal Change" (1974) 9 Law & Society Rev. 96 [Galanter, "Why the 'Haves' Come Out Ahead"]. That the primary objective of a player in Galanter's model is to win rules of law favourable to its side, suggests their centrality.

[3]See for example, F. Schauer, "Easy Cases" (1985) 58 S. Cal. L. Rev. 426–438 [Schauer], arguing that the textual language and precedent of the law limit its permissible interpretations.

[4]See for example, M.D. Rosen, "Nonformalistic Law in Time and Space" (1999) 66 U. Chi. L. Rev. 623, "'Standards' are laws that describe a triggering event in abstract terms that refer to the ultimate policy or goal animating the law." Nearly all academics subscribe to one or the other version of the conventional view. See for example, R.H. Pildes, "Forms of Formalism" (1999) 66 U. Chi. L. Rev. 620, "To be sure, as Hart and Sacks recognized, there is much at stake in our age over whether the central products of our modern legal system – statutes – are read literally or purposively."

conventional view acknowledges written law to be ambiguous or indeterminate, it assumes, as the original Realists did, that the effect is to lodge power in the judges.[5]

By any version of the conventional view, the role of lawyers is relatively minor. They gather facts, conduct research in the appropriate legal materials, and then attempt to persuade the courts to reach outcomes that favour their clients.[6] In most disputes, no litigation will be necessary; the written law will be sufficiently clear that the lawyers will agree on what the outcome of litigation would be. In the vast majority of the disputes that are litigated, the views of judges and juries will determine outcomes. Only in a small minority could lawyers determine outcomes, and then only by persuading the judges or juries.

Oddly, this conventional view coexists with another that sees the legal process as highly manipulable through legal strategy.[7] Star litigators – or "dream teams" of them – can regularly win judgments in cases that have no merit,[8] prevent meritorious cases from ever reaching trial,[9] turn victims into wrongdoers,[10] and make the system set the guilty free.[11] Though some might dispute the particular examples of

[5]See for example, F.S. Cohen, "Transcendental Nonsense and the Functional Approach" (1935) 35 Colum. L. Rev. 842–847, presenting a "theory of legal decisions" that assumes social forces are given effect through the judge.

[6]But see T.M. McDonnell, "Playing Beyond the Rules: A Realist and Rhetoric-Based Approach to Researching the Law and Solving Legal Problems" (1998) 67 UMKC L. Rev. 290–300, rejecting formalism and proposing in consequence that law schools teach students to research judges, lawyers, and other participants in litigation.

[7]See for example, L. Katz, "Form and Substance in Law and Morality" (1999) 66 U. Chi. L. Rev. 566 [Katz], presenting six "familiar examples" of controversial legal strategy); See also 595, concluding that "[l]awyers routinely exploit law's formality."As employed in this Article, "strategy" has been defined as "the art of devising or employing plans or stratagems toward a goal." Merriam-Webster's New Collegiate Dictionary, 10th ed. (1996) 1162. A "stratagem" is "a cleverly contrived trick or scheme for gaining an end." ibid, see also H.D. Lasswell, and M.S. McDougal, *Jurisprudence for a Free Society* (1992) 1046 [Lasswell and McDougal], "A strategy is a sequence of practices in which base values are utilized to influence outcomes and effects."

[8]For example, Dow Corning is settling the breast implant cases for over $2 billion even though the scientific evidence seems clear that silicon cannot cause the injuries claimed. See G. Kolata, "A Case of Justice, or a Total Travesty? How the Battle over Breast Implants Took Dow Corning to Chapter 11" N.Y. Times, (13 June 1995) D1, stating that there is no scientific evidence that implants cause serious disease.

[9]See generally for example, J. Harr, A Civil Action (Vintage, 1995) [Harr], demonstrating that financial pressures on plaintiffs' attorneys made it virtually impossible for them to take a case to trial.

[10]See for example, W.T. Pizzi, and W. Perron, "Crime Victims in German Courtrooms: A Comparative Perspective on American Problems" (1996) 32 Stan. J. Int'l L. 46, referring to the American legal strategy of "attacking the victim's character while keeping the defendant's prior record away from the jury."

[11]Only an omniscient observer could attest that a guilty person had been set free. But skilled defense lawyers have freed defendants against whom the evidence could hardly have been more compelling. See for example, W.W. Hodes, "Lord Brougham, The Dream Team, and Jury Nullification of the Third Kind" (1996) 67 U. Colo. L. Rev. 1077, arguing that O.J. Simpson's lawyers did not act unethically in obtaining his acquittal even though the evidence suggested guilt; See also J. Mathews, "DeLorean Acquitted of All Eight Charges in Drug-Scheme Trial" Wash.

manipulation that we give, the belief that strategies often determine legal outcomes is widespread and generally consonant with the reality of legal practice. Lawyers devote substantial time and energy to the development of legal strategies and regard them as capable of determining outcomes across a wide spectrum of cases.

Even though the best strategies are case-specific and must of necessity remain secret, entire publications are devoted to those that are general and that lawyers are willing to divulge.[12]

This Article argues that the strategic view captures the reality of the legal process while the conventional view misses it. The unpleasant implications that follow from the strategic view[13] explain in part why the conventional view has continued to dominate.[14] But perhaps an even greater impediment to recognition of the importance of legal strategy has been the lack of a coherent theory to explain how lawyers can overcome both law and judicial discretion to generate the pattern of legal outcomes.

Legal strategy is curiously absent from the realm of legal theory.[15] Extensive accounts of the adversary process do not even mention it.[16] The law-and-society

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Post, (17 Aug. 1984) A1, reporting that John Z. DeLorean was acquitted of all charges even though he was "caught on videotape discussing cocaine deals with government agents posing as drug dealers"; See also J. Needham, "The Lure of Fame, Fortune; Bruce Cutler Defended a Mob Don; Now a High-Profile Case Brings Him West" L.A. Times, (28 Apr. 1992) E1, noting that John Gotti, the head of the Gambino crime family, was acquitted all three times that Bruce Cutler defended him but convicted in a case in which the court barred Cutler from representation.

[12]See generally D.B. Baum et al., *Advanced Negligence Trial Strategy* (Practicing Law Institute, 1979) 83–98, providing a sample opening statement presented in an actual products liability case; See also X. Frascogna, *Negotiation Strategy for Lawyers* (Prentice-Hall, 1984), providing "a comprehensive treatment of the various patterns, principles and techniques that govern negotiation in the context of a law practice"; See also S.N. Gazan, *Encyclopedia of Trial Strategy and Tactics* (Prentice-Hall, 1962) 75, describing the importance of a trial lawyer's knowledge of psychology to defense jury selection strategy; See also C. Rothenberg, *Matrimonial Litigation: Strategy and Techniques* (1972), discussing strategies for selecting a jury that would likely be more favourable to a plaintiff seeking divorce. There are also entire periodicals devoted to legal strategy. See generally for example, Bankruptcy Strategist, Computer Law Strategist, Corporate Tax Strategy, The Journal of Strategy in International Taxation, Deposition Strategy: Law and Forms, Employment Law Strategist, and Intellectual Property Strategist.

[13]See below Part 4.4.

[14]Another part of the explanation is the understandable reluctance of lawyers who engage in strategy to admit that they do so. The use of strategy is often condemned as unethical, see below Part 4.5, and the articulation of strategy tends to destroy its effect, see W.O. Weyrauch, and M.A. Bell, "Autonomous Lawmaking: The Case of the 'Gypsies'" (1993) 103 Yale L.J. 379 n. 243 [Weyrauch and Bell]. Together, these two factors remove practicing lawyers – the persons most knowledgeable about strategy – from the discussion of its role in the legal system.

[15]But see Lasswell and McDougal (n 7) 1067–1073, listing strategic decisions made by lawyers during litigation; Katz (n 7), arguing that strategy operates in the realm of law in essentially the same manner that it operates in the realm of morality.

[16]See for example, "Professional Responsibility: Report of the Joint Conference" (1958) 44 A.B. A. J. 1161, distinguishing vigorous advocacy from "muddy[ing] the headwaters of decision"; But also see J. Frank, *Courts on Trial: Myth and Reality in American Justice* (Princeton University Press, 1949) 82–90 [Frank], describing adversarial presentation in terms of strategy and tactics.

literature has explored differential case outcomes extensively,[17] but aside from the exploration of case-selection strategy initiated by Galanter,[18] has not attempted to explain how legal strategy could generate them.

Strategy plays a central role in three methodologies employed in law and economics: economic modelling, game theory, and gaming. But the strategy explored by law-and-economics scholars is fundamentally different from that practiced by lawyers. The economic actor either yields to the rule of law and seeks maximum advantage under it, or violates the rule and accepts the consequences.[19] The legal strategist, by contrast, often seeks to defeat the rule of law in a manner that avoids the penalty as well.

To make the same point another way, the economic model treats the lawmaker – like the game designer – as omnipotent.[20] In that model, players cannot challenge the rules; they can only seek advantage under them. Yet a central thrust of legal strategy is to control legal outcomes despite the contrary intentions of legislators or judges.[21]

This Article seeks to explain the relationship between law, judges, and legal strategy, and in so doing, to offer a theory that explains what lawyers do when they strategize. The principal task, as we see it, is to generalise from what seems to be an infinite number of imaginative, clever, fact-specific manoeuvoers to a theory of what strategy is and how strategy can defeat both the rules of law and the judges who interpret those rules. As part of that task, we attempt to distinguish the strategic perspective from competing perspectives, to identify the materials from which lawyers construct their strategies,[22] to catalogue the variety of legal strategies they construct,[23] and to explore the implications of our theory.[24]

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[17]See D. Farole, "Reexamining Litigant Success in State Supreme Courts" (1999) 33 Law & Soc'y Rev. 1043–1058 [Farole] for review of the literature. This literature often refers to "legal strategy" as the means by which skilled lawyers influence outcome, but it does not attempt to explain what the skilled lawyers do to influence outcome. See for example, S.C. Tauber, "The NAACP Legal Defense Fund and the U.S. Supreme Court's Racial Discrimination Decision Making" (1999) 80 Soc. Sci. Q. 326, referring to "skillful legal argument" and "compelling legal argument."

[18]See Galanter, "Why the 'Haves' Come Out Ahead" (n 2); See also below Part 4.2; Legal strategy is not, of course, the only thing that may be in the black box driving outcomes.

[19]Professor C. Williams has dubbed this view the "law as price" view of law and criticised it as an attitude toward compliance. See C.A. Williams, "Corporate Compliance with the Law in the Era of Efficiency" (1998) 76 N.C. L. Rev. 1267–1268. The point we make here is unaffected by hers.

[20]See K. Basu, The Role of Norms and Law in Economics: An Essay of Political Economy, (1997) 15–17 (unpublished, on file with the Duke Law Journal) [Basu], arguing that judges should be regarded as players in the economic game.

[21]See for example, *Meacham Corp. v. United States*, (1953) 207 F.2d 544 (4th Cir.), "[T]hey employed the New York lawyers to find a way through the stone wall of the statutes. . .."

[22]See below Part 4.2.

[23]See below Part 4.3.

[24]See below Part 4.4.

Our theory can be summarised as follows: "Law" has direct effect through the rendition and enforcement of judgments in actual cases and indirect effect through the anticipation of such rendition and enforcement in hypothetical cases. Each such case is a complex undertaking that may require hundreds of strategic decisions by the parties and generate an indefinite number of actual or potential legal issues and extra-legal problems. The "merits" of the case, as conventionally conceived, may be only one among them.[25] Each of those decisions, issues, and problems is potentially outcome determinative. The odds that any one will determine the outcome are small. But cumulatively, the odds that some combination of these decisions, issues, and problems will determine the outcome are large.

The legal strategist manipulates those odds in a game of skill, expanding and developing the array of decisions, issues, and problems in a manner calculated to confuse and ultimately overwhelm the opponent.[26] Even if the "merits" should ever reach a decision-maker, it will be a decision-maker identified by the game, and the "merits" will reach that decision-maker in a form determined by the game.

We assume that courts are generally hostile to legal strategy and will seek to nullify it when they can. In contrast to prominent scholars who consider formalism a precondition to strategy,[27] we assume a thoroughly realist concept of law that leaves to judges, a broad range of freedom in their decision-making. Still, we conclude that, within the wide range of what is culturally acceptable in legal outcomes, legal strategies are the primary determinants of who will decide cases, under what constraints, and with what consequences. Written law is just one of several kinds of normative material the system uses, and it is not even the most important.

Part two begins by defining the terms we use to refer to various concepts of law and strategy. This second section then describes the fluid nature of legal doctrine that renders it displaceable by social norms and the prejudices of the decision-maker and explains how the strategist exploits those norms and prejudices. Lastly, this section notes the residual role of legal doctrine in a world dominated by strategy.

Building on the theory propounded in part two, part three employs three main categories to catalogue the wide variety of activities referred to as "legal strategy":

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[25]Whether an issue constitutes the merits or is merely procedural or tangential is itself frequently the subject of legal strategy.

[26]See for example, A. Davis, "How a Lawyer Turned Tables in Tobacco Case" Wall St. J., (4 Oct. 1999) B1, noting a speech by tobacco company lawyer William Hendricks III "about how prosecutors can be 'mortally wounded' when they decide to skirmish over legal and factual issues in court before indictments are handed up"; See also J. Gibeaut, "Another Broken Trust" A.B.A. J., (Sept. 1999) 41, describing the Indian trust case as "spinning out of control" as a result of discovery decisions and missed strategic opportunities. To the extent that cases are decided on the merits, they cannot "spin out of control" before their conclusion. Nor can an agreement to *give* discovery compromise them in any way.

[27]See for example, D.A. Farber, "Legal Formalism and the Red-Hot Knife" (1999) 66 U. Chi. L. Rev. 604 [Farber], "A formalistic system puts a great premium on people (particularly lawyers) who are able to invent clever ways to manipulate the rules to produce desired outcomes"; See also Katz (n 7) 595, "Lawyers routinely exploit law's formality."

strategies that seek to persuade the judge, strategies that seek to constrain the judge, and strategies that seek to strip the judge – and the law – of all power over case outcome. Part four identifies the principal implications of the theory we propose. Our theory explains why strategy can so dramatically affect legal outcomes, how strategy drives changes in law, the source and mechanisms of the set of variations in law commonly referred to as "legal culture," and why ingenuity and resources together are so effective in determining legal outcomes. Part five concludes that strategy, not law, is the principal determinant of legal outcomes, that awareness of strategy is likely to increase with growing public access to data on legal outcomes, and that legal systems should be redesigned consciously to minimise strategic opportunities.

At the same time, the theory we present does not depend upon a high level of indeterminacy in legal rules. Merely assuming that there is indeterminacy on some issues provides the flexibility necessary to render the ultimate outcomes of nearly all cases indeterminate. Small amounts of indeterminacy on each of the numerous issues that constitute a case combine to generate large amounts of potential variance in outcomes.[28]

4.2 The Foundations of Legal Strategy

A strategy is a plan for action intended to accomplish some goal.[29] It presumes some "field of play" – people, data, or things that can be rearranged. The chess strategist arranges pieces by sequences of moves. The war strategist arranges troops, weapons, and propaganda. In either arena, the first task of the strategist is to understand the people, data, and things the strategist can manipulate directly.

The legal strategist works with decision-makers, facts, legal cultures and law. The decision-makers are judges, juries, arbitrators, administrators, boards, commissions, lawyers, and parties. The facts are events, both past and future. Those events morph into statements of fact, evidence, testimony, records, and finally the "facts" stated in court opinions. Legal cultures are sets of practices, perceptions, and expectations that differ from group to group and are often outcome-determinative.[30] The "law" is perhaps the most difficult of the four elements to conceptualise for the purpose of a theory of legal strategy. Misunderstanding the nature of law has

[28]One of us has argued elsewhere that "[t]he outcome of a case can be predicted more accurately at the level of the whole case than at the level of the case-dispositive decisions within the case that supposedly produce the outcome." See L.M. LoPucki, "Legal Culture, Legal Strategy, and the Law in Lawyers' Heads" (1996) 90 Nw. U. L. Rev. 1527 [LoPucki, "Legal Culture, Legal Strategy"]. This "whole-case realism" puts a damper on what can be accomplished through legal strategy. It is also worth noting that the predictions of whole-case realism referred to are not made from law, but from community expectations regarding outcomes.

[29]See (n 7) defining "strategy."

[30]See below Part 4.3, discussing the rise and fall of local legal cultures.

probably been the principal impediment to the integration of strategy into legal theory. If law were what some conventional theorists conceive it to be – a set of written rules that specify comprehensively the appropriate outcomes for various fact patterns – legal strategy could have far less impact on outcomes.

4.2.1 Definitions of Law

By what is probably the most common definition, "law" is a set of rules and standards promulgated by the state to govern conduct. In the American legal system, these rules and standards appear in statutes, court rules, court opinions, regulations, ordinances, and the like. This definition excludes social norms (the rules that spontaneously arise in groups of all sizes),[31] oral legal traditions, and private contracts,[32] even though the sanctions for violation of any of the three may be severe. This definition includes the "law on the books" whether or not it is in fact honoured in the operation of the legal system. In the remainder of this Article, we will refer to the law thus described as "written law" or as "legal doctrine."[33]

Two leading Realists, Oliver Wendell Holmes, Jr. and Karl N. Llewellyn, used the word "law" to refer to what courts or other participants in the legal system will do in fact. As Holmes put it:

> Take the fundamental question, What constitutes the law? You will find some text writers telling you that it is something different from what is decided by the courts of Massachusetts or England, that it is a system of reason, that it is a deduction from principles of ethics or admitted axioms or what not, which may or may not coincide with the decisions. But if we take the view of our friend the bad man we shall find that he does not care two straws for the axioms or deductions, but that he does want to know what the Massachusetts or English courts are likely to do in fact. I am much of his mind. The

[31]The term "social norm," as we use it here, includes the "sense of appropriateness developed in the [legal] profession and the public over time [but not expressed in legal rules]" that Dworkin refers to as "legal principles." R. Dworkin, *Taking Rights Seriously* (Harvard University Press, 1977) 40.

[32]Broader definitions often include one or more of these. See for example, W.M. Reisman, *Law in Brief Encounters* (Yale University Press, 1999) 2, "The law of the state may be important, but law, real law, is found in all human relations, from the simplest, briefest encounter between two people to the most inclusive and permanent type of interaction"; See also Weyrauch and Bell (n 14) 326–329, including oral legal traditions within the meaning of "law"; See also Weyrauch, "Unwritten Law" (1999) Wash. & Lee L. Rev. 1236 [Weyrauch, "Unwritten Law"], suggesting that overreliance on written law "by Texaco's lawyers contributed to, if not caused, the loss of the case" in *Texaco Inc. v. Pennzoil Co*., (1987) 729 S.W.2d 768 (Tex. App.), rev'd, 481 U.S. 1.

[33]Some writers include written law within the category of social norms. See for example, W.K. Jones, "A Theory of Social Norms" (1994) U. Ill. L. Rev. 546, "For the present, I encompass all rules and standards, without regard to their origins or means of enforcement [within the definition of social norm]. The legal system provides important norms and usually stipulates sanctions for deviant behavior."

> prophecies of what the courts will do in fact, and nothing more pretentious, are what I mean by the law.[34]

Llewellyn expanded Holmes's definition to include the actions of officials, including lawyers.[35] This conception of law ignores "rules of law" that are not enforced and ascribes to those that are enforced, the same meaning given them by the officials. Using Pound's terminology, we will refer to this conception of law as the "law in action."[36]

Law, social norms, and physical constraints are, as means of social control, largely interchangeable.[37] Hence, we would add to Holmes's and Llewellyn's definitions of law, the effects of social norms and physical constraints to the extent they contribute to legal outcomes. The resulting conception of law, which we refer to as "delivered law,"[38] attempts to link fact patterns with outcomes in a manner that is sensitive to "how much the [legal] system will cost, how long the system will take, what the system will require of the client along the way, and what the system will deliver in the end."[39] Delivered law is the pattern of outcomes the legal system delivers.

As one of us has argued elsewhere, the lawyers, judges, and other officials who regularly interact in the processing of cases in a legal community forge and share mental models of the law that are both different from and simpler than the written law.[40] They process routine cases according to the model, referencing the written law only when the model is challenged. For example, the law on the books provides complex, subjective tests for determining whether loans from insiders must be subordinated under a Chapter 11 plan. In the district in which one of us practiced, the delivered law was that debts owing to insiders could not be subordinated. At the same time, the delivered law of another district was that debt owing to insiders had to be subordinated. The lawyers and judges who processed cases in each district

[34]O.W. Holmes, "The Path of the Law" (1897) 10 Harv. L. Rev. 460–461.

[35]See Llewellyn, *The Bramble Bush* (n 1) 3: "This doing of something about disputes, this doing of it reasonably, is the business of law. And the people who have the doing in charge, whether they be judges or sheriffs or clerks or jailers or lawyers, are officials of the law. *What these officials do about disputes is, to my mind, the law itself.*"

[36]R. Pound, "Law in Books and Law in Action" (1910) 44 Am. L. Rev. 19, describing the latter as "adjusting the letter of the law to the demands of administration in concrete cases."

[37]See L.M. LoPucki, "The Systems Approach to Law" (1997) 82 Cornell L. Rev. 488–491 [LoPucki, "The Systems Approach to Law"], describing the use of law, social norms, and physical constraints in the construction of law-related systems.

[38]See LoPucki, "Legal Culture, Legal Strategy" (n 28) 1551–1555, explaining the term "delivered law."

[39]Ibid 1551.

[40]See ibid 1516–1520; see also M.V. Tushnet, "A Note on the Revival of Textualism in Constitutional Theory" (1985) 58 S. Cal. L. Rev. 688, n. 24, arguing that "easy cases" do not exist in written law, but seem to exist "because the lawyers are socialized into and are part of a way of life that defines the cases as easy."

probably shared a mental model of the law that validated the law delivered in their district.[41] That model was nowhere reduced to writing. We will refer to the law contained in these mental models as "the law in lawyers' heads."[42]

Finally, oral legal traditions that parallel but do not coincide with the other forms of law arise spontaneously in social groups.[43] Weyrauch and Bell[44] and others,[45] most notably Robert Ellickson,[46] have noted the ability of these informal rules to displace state-made law.

Some oral legal traditions, however, do not fit easily within the category of "social norms" because they appear, not in the form of rules that purport to govern behaviour, but in the form of shared expectations about the outcomes which are appropriate under a given set of facts. For example, a particular community might expect that a youthful first offender should not do jail time for possession of a small amount of marijuana. We refer to the latter kinds of oral legal traditions as "expectations regarding outcome."

4.2.2 The Relationship Between Written Law, Social Norms, and Expectations Regarding Outcomes

Conventional legal theory regards the written law as specifying a set of rules that govern both social interaction and dispute resolution.[47] For nearly any set of facts, the theory posits, written law specifies the appropriate outcome.[48] The theorists who subscribe to this view acknowledge the existence of "gray areas" in which the appropriate outcomes are unclear.

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[41]See LoPucki, "Legal Culture, Legal Strategy" (n 28) 1504–1505, presenting this example in more detail.

[42]See ibid 1500.

[43]See Weyrauch and Bell (n 14) 326–333. See generally Weyrauch, "Unwritten Law" (n 32), describing the unwritten rules governing three isolated social units.

[44]See Weyrauch and Bell, ibid 331, n. 16, postulating hypotheses about the relationship between informal private law and traditional state law.

[45]See for example, M. Gulati and C.M.A. McCauliff, "On Not Making Law" (1998) 61 Law & Contemp. Probs. 161, noting with regard to the opinion publication practices of the federal courts of appeals that "the behavior of judges is primarily governed by internally generated norms that can be altogether different from the officially stated organizational rules."

[46]See R.C. Ellickson, *Order Without Law* (Harvard University Press, 1991) [Ellickson], arguing that social norms are capable of displacing law.

[47]See for example, Schauer (n 3) 407, explaining that "the Constitution channels and constitutes American public and private life."

[48]But see *Lochner v. New York*, 198 U.S. 76 (1905) (Holmes, J., dissenting), "General propositions do not decide concrete cases. The decision will depend on a judgment or intuition more subtle than any articulate major premise."

In their view, social norms, prejudices, public policies, and social expectations are relevant only in the small minority of cases of first impression or cases in which litigants seek a change in the law to reflect modern conditions.[49]

The theory we present here regards delivered law as the product of complex interactions among written laws, law in lawyers' heads, social norms, law in action, system imperatives, and expectations regarding outcomes. Legal strategists, who include lawyers, clients, judges, legislators, other officials, and sometimes persons who have not yet retained a lawyer or even become involved in a dispute, are the catalysts for these interactions. Through these strategic interactions, they construct the pattern of legal outcomes. Within broad cultural limits, the strategies these participants pursue and the quality with which they execute them – not law or judges – determine that pattern.[50]

Social norms and expectations regarding outcomes specify "just" or "fair" outcomes for virtually all human interaction, including interactions directly addressed by written law or the law in lawyers' heads.[51] In regard to those interactions, the norms or expectations are often congruent with the written law and/or the law in lawyers' heads, but often they are not. One can easily think of examples of situations in which the written law requires one pattern of conduct, but social norms permit or require another. For example, the written law may applaud and protect the whistleblower at the same time that social norms render him or her unemployable.[52]

These norms specify – though with considerable imprecision – the socio-legal entitlements of members of the group. Though the written law may seem to entitle the bank to call the loan "on demand,"[53] the social norm may require that the bank

[49]See for example, *Hoffman v. Jones*, (1973) 280 So. 2d 436 (Fla.), changing the law in Florida from contributory negligence to comparative negligence because "contemporary conditions must be met with contemporary standards."

[50]As Lawrence Friedman has put it, "what makes a theory or a strategy 'persuasive' or winning is culturally and historically determined." Letter from L.M. Friedman, M. Rice Kirkwood Professor of Law, Stanford Law School, to W.O. Weyrauch, S.C. O'Connell Chair and Distinguished Professor, University of Florida College of Law (5 Aug. 1999) (on file with the Duke Law Journal).

[51]See Ellickson (n 46) 69–81, describing a system of norms that addresses the same subject as section 841 of the California Civil Code-determining who pays the costs of boundary fences.

[52]See D. Culp, "Whistleblowers: Corporate Anarchists or Heroes? Towards a Judicial Perspective" (1995) 13 Hofstra Lab. L.J. 112, noting that most whistleblowers "have been fired, blackballed from their industry or profession, and have suffered personal problems"; See also R.W. Painter, "Toward a Market for Lawyer Disclosure Services: In Search of Optimal Whistleblowing Rules" (1995) 63 Geo. Wash. L. Rev. 295, describing the present regime with regard to lawyers as "a mandatory nonwhistleblowing regime."

[53]U.C.C. §1-208 cmt. (1997), providing that the U.C.C. good faith requirement "has no application to demand instruments or obligations whose very nature permits call at any time with or without reason."

act with some consideration for the borrower.[54] Though the written law may regard the employer as entitled to discharge the employee "at will," the social norm may prohibit discharge for certain "unjust" reasons.[55] Strategists who acquire the property of others in "perfectly legal" transactions may nevertheless be regarded as thieves.[56]

Conventional legal theory assumes wrongly that decision-makers will apply written law to the exclusion of social norms,[57] maintains falsely that expectations regarding outcomes are the direct product of written law, and does not even recognise the existence of the law in lawyers' heads.[58] Were these assumptions accurate, legal strategists would have relatively few tools to employ. In fact, written law is sufficiently malleable that decision-makers can interpret it to support virtually any position that finds support in social norms or expectations regarding outcomes.[59] That is, whatever exists in a fact pattern that gives rise to rights or entitlements under social norms will find support in legal doctrine.[60] As the

[54]See *KMC v. Irving Trust Co*., (1985) 757 F.2d 752, 760 (6th Cir.), applying U.C.C. §1-208 to require good faith in calling a demand note; See also J. Steinbeck, *The Grapes of Wrath*, (1939) 32–35, describing Oklahoma Depression-era farm repossessions as little different from theft of property.

[55]See E.B. Rock, and M.L. Wachter, "The Enforceability of Norms and the Employment Relationship" (1996) 144 U. Pa. L. Rev. 1929, arguing that a clear norm forbids firing an employee without cause, despite the employee's formal at-will status.

[56]See for example, J.B. Cahill, "Title-Loan Firms Offer Car Owners a Solution That Often Backfires" Wall St. J., (3 Mar. 1999) A1, referring to auto-title lending as "legalized extortion."

[57]Professor Robert Burns describes the conventional view as follows: "The Received View understands the trial as a necessary institutional device for actualising the Rule of Law in situations where there are disputes of fact. The trial allows punishments to be imposed or civil wrongs to be righted only after a careful factual analysis of what actually occurred, specifically structured for the exclusive application of an established legal rule to the exclusion of other possible norms." See R.P. Burns, "Some Realism (and Idealism) About the Trial" (1997) 31 Ga. L. Rev. 717.

[58]See generally LoPucki, "Legal Culture, Legal Strategy" (n 28), arguing that legal culture determines mental models of law in lawyers' heads which leads to differing laws in different communities.

[59]The matter has been the subject of extensive debate. See A. D'Amato, "Aspects of Deconstruction: The 'Easy Case' of the Under-age President" (1990) 84 Nw. U. L. Rev. 251–256 [D'Amato], collecting sources. Our argument does not depend, however, on the outcome of that debate. Our statement in the text is what we consider to be the best explanation of the legal strategy phenomenon.

[60]The empirical test of this proposition is whether one can find a real case or invent a realistic hypothetical in which no legal doctrine exists by which a court could reach the outcome that accords with the applicable social norms. Professor D'Amato makes this point another way, arguing that some cases appear easy to decide in accord with the written law only because no dispute exists. With respect to Lawrence Solum's candidate for the irrefutable easy case – if a homeowner eats ice cream in the privacy of her home, it will not give rise to any legal action – D'Amato responds: "But there is no dispute here! No one is claiming that the homeowner has injured anyone else by eating ice cream, and hence there is no occasion to cite a legal rule that she may have violated. There is, in short, no 'case.' Professor Solum must supply us with a posited but real harm to someone resulting from the homeowner's action in order to have a person who could make a claim against her." D'Amato ibid 256. By a "dispute," D'Amato obviously means the social basis for a dispute, and by an "injury" he must intend one socially recognised as a wrong.

language of written law departs from the entitlements of parties under social norms, that language becomes less effective.[61]

The view that written law drives legal outcomes is plausible only because written law (to the extent that it has any meaning at all) is usually in accord with social norms. The outcomes of cases in which the applicable norms differ from the written law demonstrate that the norms, not the written law, are the driving force.[62] While written law is sufficiently flexible to support virtually any social norm, the social norms of a particular group are not sufficiently flexible to support virtually any written law.

Social norms differ from group to group and place to place. The geographical boundaries within which particular norms prevail are not congruent with the jurisdictional boundaries of the written law. Because the strategist can draw from such a wide variety of conflicting social norms and written legal doctrines, the strategic possibilities are virtually limitless.[63]

Cases in which the decision-maker sincerely[64] opines that a particular party should have won, but the law required a contrary result, are virtually always cases in which the party's lawyer failed to pursue the most persuasive legal theory.

High-stakes litigation is fought principally on two issues. The first issue is who will decide the case.[65] The second is who should win according to the values of, or the norms adhered to by, the decision-maker. Parties can use legal doctrine to persuade decision-makers that they should win, but legal doctrine is only one tool for doing so. It is seldom an effective one, because it inevitably carries within it support for the opposing position.[66]

The "social" in this characterisation is a reference to social norms. Thus, D'Amato's response to Solum's example is that no legal doctrine supporting a contrary result should be expected, because no social norm supports the contrary result.

[61]See Farber (n 27) 604, "Of course, the more counterintuitive the outcome – the more it violates what seems to be the purpose of the rule or runs against social norms – the harder the task [manipulation of written law] becomes and the more valuable are the [manipulation] skills involved."

[62]See K. Llewellyn, *The Case-Law System in America*, Michael Ansaldi trans. (University Of Chicago Press, 1989) 82–83, "Legal rules provide certainty in the affairs of people whose interests are affected by law if, in a lawsuit, they yield a result that accords with their real-life norms." Professor Basu has reached essentially the same conclusion through economic analysis. See Basu (n 20) 15–17, arguing that law cannot reach outcomes unsupported by norms.

[63]See below Part 4.3.

[64]In some cases, the judge will not be sincere. He or she will use the supposedly binding force of the law as an excuse for doing what he or she is inclined to do anyway.

[65]See below Part 4.3.5.

[66]The difference is ultimately a product of the different forms in which the two kinds of rules exist. Because law is written and the procedures for changing it are cumbersome, those who administer it have introduced conflicting meta-rules that render it malleable with respect to any given case. An example of conflicting meta-rules are the rules of stare decisis and obiter dicta. The first holds that a court is bound to follow precedent. The second holds that statements made in decision that were not necessary to the decision are of no effect. A court that wishes to narrow a rule to exclude the case before it has merely to distinguish the precedent in some respect and then invoke the rule of

The task of persuading the decision-maker at the normative level is often an urgent one. Decision-makers, particularly those who conceptualise law as a generally consistent set of rules that inform and bind their decisions, may frame the issue in accord with the first persuasive argument and be unable to give fair consideration to equally persuasive but conflicting arguments.[67] Once the decision-maker is persuaded at the normative level, the task of persuasion at the doctrinal level is easier and less urgent. The strategist need only provide the decision-maker with legal doctrine that plausibly links the facts of the case to the strategist's desired conclusion. That other legal doctrines plausibly link the facts to other conclusions presents no real danger at this late stage. Presented with a bridge to the "right" conclusion, the decision-maker is unlikely to adopt a doctrinal rationale that leads to a conclusion he or she believes is wrong.

The basic strategy outlined here – persuade the decision-maker and provide a doctrinal bridge to the desired result – is capable of producing virtually any result consistent with the decision-maker's values. This does not mean, however, that the system is capable of doing so in every case. The kind of lawyering required for such strategy is skilled, time-consuming, and therefore expensive. For lawyers to do it too frequently may violate the local legal community's norms for case processing.[68] In low-stakes cases, considerations of cost and case-processing resources are likely to dominate, producing outcomes in accord with the law in lawyers' heads.[69]

4.2.3 The Residual Role of Legal Doctrine

Written law is less influential in the legal system we have described than it is in common understanding. Though the large majority of decisions will appear to be in accord with law, they are in no meaningful sense the product of it.[70]

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obiter dicta to prevent the precedent from governing. The court that wishes to apply the rule to the case before it simply recites that whatever differences exist between the two cases are unimportant. See Llewellyn, *The Bramble Bush* (n 1) 74–75, discussing the ability of courts to employ this technique to expand or narrow precedents. There are many other examples of conflicting meta-rules. See for example, K.N. Llewellyn, "Remarks on the Theory of Appellate Decision and the Rules or Canons About How Statutes Are to Be Construed" (1950) 3 Vand. L. Rev. 401–406 [Llewellyn, "Remarks on the Theory of Appellate Decision and the Rules or Canons About How Statutes Are to Be Construed"], setting forth opposing canons of statutory construction.

[67]See F.E. Cooper, *Living the Law,* (Bobbs-Merrill, 1958) 161 [Cooper, *Living The Law*], suggesting that "the initial impression counts more than all the rest of the argument." But see W.C. Costopoulos, "Persuasion in the Courtroom" (1972) 10 Duq. L. Rev. 392–395, contending that the advantage will differ from case to case.

[68]See LoPucki, "Legal Culture, Legal Strategy" (n 28) 1529–1532, describing pressures on lawyers to move matters along.

[69]See ibid at 1516–1520.

[70]See for example, F.H. Foster, "Towards a Behavior-Based Model of Inheritance?: The Chinese Experiment" (1998) 32 U.C. Davis L. Rev. 126, referring to "the much-criticized American

Legal strategy, playing on expectations regarding outcomes and social norms internalised by the decision-maker, determines case outcomes.[71] The rules of the written law are mere incantations[72] that may or may not have some effect on the decision-maker. Unsupported by norms, the rules become impotent technicalities, "scrivener's errors," or dead letters.[73]

Though our theory may at first seem to exclude written law from legal system content, it does not do so entirely. First, unskilled parties or their lawyers can render indeterminate law determinate through admissions that characterise the facts in such a way that particular adverse doctrine applies or through concessions that adverse doctrine applies. The legal process deliberately pressures lawyers and parties to make such admissions.[74] Theoretically, one can deny every allegation and object to every piece of evidence. But in practice, a pattern of such denials and objections quickly discredits both parties' witnesses and their lawyers. The lawyers may be marginalised and ultimately ostracised.[75] Lawyers must appear to be constructively engaged in a process that "narrows the issues" in preparation for the court's decision.[76] Often, they come under intense pressure to admit facts or the applicability of law before they can entirely predict the effect of their admissions.[77] Once a party has, against its own interests, admitted each of the facts in the antecedent of a rule[78] in the language of that rule, the court may no longer have any alternative but to apply the rule. In such a case, legal doctrine may compel a particular outcome.

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tradition of judicial subterfuge, in which courts claim to follow statutory rules and testators' intent rigidly but in fact manipulate equitable doctrines to effect estate distributions that comport with judges' individual standards of fairness and justice."

[71]See Basu (n 20) 22, concluding that "[i]f a certain outcome is not an equilibrium of the economy, then it cannot be implemented through any law."

[72]See W.O. Weyrauch, "Taboo and Magic in Law" (1973) 25 Stan. L. Rev. 798–800, analogising "magic and magicians to law and lawyers."

[73]See for example, *Holloway v. United States,* (1999) 526 U.S. 1, 19 n.2 (Scalia, J., dissenting), noting that the doctrine of "scrivener's error" gives the Court the authority to "correct" a statute that does not have a "plausible purpose." Absent legislative history describing its purpose, any statute that is contrary to established social norms will appear to be without plausible purpose and hence an appropriate candidate for correction.

[74]See for example, *Berkowitz v. Home Box Office, Inc*., (1996) 89 F.3d 27–28 (1st Cir.), describing district court pressures on parties to communicate their factual and legal theories; See also *J.F. Edwards Constr. Co. v. Anderson Safeway Guard Rail Corp*., (1976) 542 F.2d 1326–1327 (7th Cir.), appending a standing order on pretrial conferences ordering parties to stipulate to the "uncontested facts" and to recite their own versions of the contested facts.

[75]See LoPucki, "Legal Culture, Legal Strategy" (n 28) 1531, indicating that lawyers who engage in such behaviour may become "ineffective in that community."

[76]See cases cited (n 74); See also Cooper, *Living The Law* (n 67) 43–50, addressing the importance of an attorney's formulation of the issues to the final decision.

[77]Thus, the ability to foresee the effects of admission may be the most valuable aspect of legal experience.

[78]The "antecedent" of a rule is the "if" clause once the rule has been translated into an if–then statement. See (n 89) and accompanying text.

Second, participants in the legal process may see the rules of written law themselves as norms.

That is, they may believe that a party should win because the rules of written law seem to direct that the party should win.[79] This belief is an erroneous one; written law generally obtains normative content only when decision-makers inject that content through interpretation in the particular case.[80] Some decision-makers' lack of sophistication in this regard, perhaps combined with poor lawyering on the losing sides, prevents those decision-makers from seeing this. When decision-makers feel genuinely compelled to a particular result because they believe it to be required by the rule, the result does, in a sense, follow from the rule.

That does not mean that the strategist should devote much effort to determining what result the rules compel on particular facts. The rules compel no particular result. Instead, the realisation that decision-makers may perceive themselves as compelled to accept a particular rule recommends that the strategists attempt to discover how the process settles on a particular rule. The issue is explored further in Part 4.4.

Third, even judges, who believe as we do, that law exists to support any conclusion they may choose to reach in the vast majority of cases, will continue to be concerned with the doctrinal bridges by which they explain their decisions. Some outcomes will be more popular than others among the court's constituents. Particularly when the outcome will be unpopular within an important segment of that constituency, the ability of the judge to wrap the decision convincingly in legal doctrine can be important.[81] The judge's willingness to make a particular decision may depend in part on the level of assistance counsel's briefs and arguments offer in the drafting of a persuasive opinion.

Perhaps the most important role of legal doctrine today is in maintaining the respect of the public for the legal system and the decisions it renders. The public tolerates the current system because it erroneously believes that the system operates largely according to the conventional view.[82] That is, that by and large, written laws bind judges to particular outcomes.

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[79]See Basu (n 20) 18, observing that "the law works . . . entirely through its influence on people's beliefs and opinion[s]."

[80]For example, Llewellyn states that "[i]f a statute is to make sense, it must be read in the light of some assumed purpose. A statute merely declaring a rule, with no purpose or objective, is nonsense." Llewellyn, "Remarks on the Theory of Appellate Decision and the Rules or Canons About How Statutes Are to Be Construed" (n 66) 400.

[81]See generally D. Kennedy, "Freedom and Constraint in Adjudication: A Critical Phenomenology" (1986) 36 J. Legal Educ. 518, describing the doctrinal and political constraints on judges phenomenologically.

[82]Probably the best evidence of this belief are the repeated warnings that various actions will undermine that conventional view. See for example, *Stretton v. Disciplinary Bd.*, (1991) 944 F.2d 142 (3d Cir.), confirming that "confidence of the public in the rule of law would be undermined"; See also M.C. Dorf, "Prediction and the Rule of Law" (1995) 42 U.C.L.A. L. Rev. 689, stating that use of a prediction model "would undermine the public's confidence in, and its felt obligation to, the rule of law"; See also C. Fried, "The Supreme Court, 1994 Term-Foreword: Revolutions?"

But judicial opinions are, in essence, merely propaganda on behalf of the judiciary. Their purpose is to support the belief that legal doctrine plays a role in the system that it, in fact, does not.

4.3 The Varieties of Legal Strategy

This part describes the wide variety of legal strategies currently in use. Participants in the legal system have acknowledged most of these strategies individually but not their cumulative effect. We assert that the presence or absence of these strategies, and perhaps numerous others of which we are unaware, is the predominant determinant of case outcomes.

We present our taxonomy in three parts. First, most (but not all) legal strategies seek to enlist the judge. Other legal strategies seek to pressure the judge or limit the judge's alternatives, while still other legal strategies seek to deprive the judge of any say at all in the outcome of the case.

4.3.1 Strategies Requiring Willing Acceptance by Judges

Strategies that seek to persuade the judge, jury, or other decision-maker to rule in the strategist's favour are both the most common and the most visible type. Some of these strategies of persuasion may have nothing to do with the particular case.

For example, lawyers adopt the speech, mannerism, and dress of jurors or judges as a means of gaining their confidence.[83] They attempt to undermine the credibility of adverse witnesses, even when they believe them truthful.[84] They employ

(1995) 109 Harv. L. Rev. 34, referring to the "rule of law to which the public is probably more devoted than to any specific constitutional doctrine or ruling"; See also N.K. Sethi, "The Elusive Middle Ground: A Proposed Constitutional Speech Restriction for Judicial Selection" (1997) 145 U. Pa. L. Rev. 723–724, declaring that "[l]itigants, especially those who do not prevail, must believe that judicial decisions are made on the basis of neutral criteria and are grounded on more than the judge's personal feelings"; See also J.P. Stevens, "The Life Span of a Judge-Made Rule" 58 N.Y.U. L. Rev. 9, referring to "the risk of undermining public confidence in the stability of our basic rules of law"; See also F.K. Zemans, "The Accountable Judge: Guardian of Judicial Independence" (1999) 72 S. Cal. L. Rev. 632, claiming that "attacks on judicial activism are often stated in terms that appeal to public understanding of the importance of the rule of law that requires judges to base their decisions on the law." The public's belief in the rule of law coexists with its inconsistent belief that skillful lawyers can manipulate the system to reach virtually any result. See (n 8) and accompanying text.

[83]See R. Haydock, and J. Sonsteng, *Trial: Theories, Tactics, Techniques* (West Group, 1991) 55, "Attorneys may have to put aside personal tastes and conform their dress to the standards of a community or judge so as to safeguard and promote the best interests of a client."

[84]See Frank (n 16) 82, "The lawyer considers it his duty to create a false impression, if he can, of any witness who gives [disadvantageous] testimony."

rhetorical techniques, such as theme, repetition, and innuendo.[85] They pursue "linguistic strategies," employing words and phrases that seem concrete and evoke favourable reactions, while skirting the edges of falsifiability.[86] They may attempt to construct logical arguments[87] or they may simply throw out possibilities in the hope that the decision-maker will seize upon one of them.[88]

Most strategy, however, relates to case-specific information: the evidence the lawyer will offer, the facts the lawyer will assert, or the rationale the lawyer will encourage the decision-maker to adopt. The three combine to form an argument that the decision-maker should reach a particular conclusion.

Ostensibly, the system approves only a single rationale for decisions: application of the written law to the facts proven requires the conclusion sought.[89] Even when a matter is within the "discretion" of the court, a legal standard governing the exercise of that discretion will almost certainly already exist.[90] Formally, the

[85]See for example, P.L. Murray, *Basic Trial Advocacy* (Maine Law Book Co., 1995) 97–105, advocating story-telling in the opening statement; See also at 353–378, describing the use of dramatics, body language and rhetoric in the summation; P.B. Carlisle, "In Cold Blood and the Fine Art of the Opening Statement" (1999) Nov. Hawaii B.J. 9, advocating theme and repetition in opening statements; See also E.A. Gonzalez, "Creating and Developing Winning Themes and Arguments" (1988) Feb. Fla. B.J. 53, "[Y]our trial plan should be built around a theme that will define the case and will allow the jury to rally around that theme."

[86]K.J. Delaney, Strategic Bankruptcy: How Corporations and Creditors Use Chapter 11 to Their Advantage (University of California Press, 1992) 167–168, discussing "linguistic strategies" that can help "legitimate the claim to bankruptcy"; See also 161, providing an example.

[87]See R.J. Aldisert, *Logic for Lawyers: A Guide to Clear Legal Thinking* (C. Boardman Co., 1989) 1–2, equating logical reasoning with thinking like a lawyer.

[88]See for example, W.O. Weyrauch, "Legal Practice as Search for Truth" (1985) 35 J. Legal Educ. (book review) 128–129, discussing Viehweg's advocacy of argument "based on multiple, perhaps overlapping or even contradictory, points" so that "failure of one point leaves the others intact." Logical arguments are relatively weak in the legal context because they proceed in an orderly fashion from their premises to their conclusions. Successful attack on a single element destroys the entire argument. Their order alerts decision-makers and opponents to each argument's points of vulnerability. A generally more effective alternative is to make emotionally appealing suggestions, leaving it to the decision-maker to choose among them and construct the arguments. Law professors will recognise this approach as one often employed by students on examinations, commonly referred to as "shotgunning."

[89]Even a standard that limits choices without compelling a single one logically can be recast as a rule that permits particular choices but bars others. The idea that any statute can be expressed as an if–then statement without changing its meaning originated with Layman Allen. See L.E. Allen, and C.R. Engholm, "Normalized Legal Drafting and the Query Method" (1978) 29 J. Legal Educ. 402–403, describing statutes as if–then statements; See also G.B. Gray, "Reducing Unintended Ambiguity in Statutes: An Introduction to Normalization of Statutory Drafting" (1987) 54 Tenn. L. Rev. 436–444, providing examples of statutes expressed as if–then statements. According to D. Kennedy, *A Critique of Adjudication* (Harvard University Press, 1997) 136, "The elements of the rule structure, or doctrine, are thousands of statements that have the form, 'If these facts are found, the judge should do this.'"

[90]See W.O. Weyrauch et al., *Cases and Materials on Family Law: Legal Concepts and Changing Human Relationships* (West Publishing Company, 1994) 840–842, enumerating legal standards for the "best interests of the child" in custody disputes.

argument – and the judge's explanation of the outcome – must be that application of the standard for the exercise of that discretion requires the conclusion sought.[91]

Despite the relative ineffectiveness of written law, in practice it provides the sole basis for most legal argument. Nearly all written law is sufficiently general, however, that a sophisticated opponent can find substantial ambiguity in it as it would be applied in the case at hand. The basic technique for discovering such ambiguity is a simple one. The opponent examines each word of the proffered rule for ambiguity. If even a single word is ambiguous, application of the rule is ambiguous. Once that ambiguity is demonstrated, the opponent often asserts a rule from another area of law that, if applied, would lead to the opposite result in the case at hand.[92] The proponent examines that new rule for substantial ambiguity and the process repeats itself.[93]

If a party is unable to discover ambiguity in the rule proffered by its opponent, the party can turn to any of a number of meta-rules to invalidate the unambiguous rule: the rule is unconstitutional, the rule was not properly adopted, the rule is not authoritative in this jurisdiction, the (statutory) rule constitutes a scrivener's error, the rule should be changed because of changes in technology or society since it was adopted, etc.[94] Most recently, the Supreme Court has been implicitly employing a test of "mandatory culpability" in the review of criminal convictions. That is, the defendant must not only have violated the written law; the defendant must also be "culpable."[95] This use of meta-rules to nullify rules mimics a technique employed

[91]That is, the judge cannot say that he or she was entitled to reach either result but chose one on the basis of personal preferences.

[92]See for example, *Dewsnup v. Timm*, (1992) 502 U.S. 417, finding ambiguity in statutory language stating that "[t]o the extent that a lien secures a claim against the debtor that is not an allowed secured claim, such lien is void" and then accepting an argument based on prior law and legislative history suggesting that a secured creditor's lien could "pass through bankruptcy unaffected."

[93]For example, assume that Peter buys an automobile from Paul under an installment contract. Peter misses a payment and Paul sues for possession, citing U.C.C. section 9-503. That statute provides that "a secured party has on default the right to take possession of the collateral." U.C.C. § 9-503 (1995). In searching for a defense, Peter considers whether his missed payment constitutes a "default," whether Paul is a "secured party," and whether the automobile is "collateral." If, for instance, it is unclear whether missing a payment is a default, Peter might assert the rule that a contract of adhesion is to be interpreted against the drafter. Paul would then search for an avoidance by considering whether his installment contract is one of "adhesion" and, if so, whether he is the "drafter."

[94]D'Amato provides an example in his response to Schauer's argument that the attempt of a person under 35 years of age to assume the Presidency of the United States would be an "easy case." D'Amato responds by pointing out that, through the strategy of assuming office and forcing his adversaries to bring suit, the underage President might win on the basis that the plaintiffs lack standing to sue or on grounds of mootness. See D'Amato (n 59) 253–254; See also (n 66), describing the strategic opportunities created by conflicting meta-rules.

[95]See J. Shepard Wiley Jr., "Not Guilty By Reason of Blamelessness: Culpability in Federal Criminal Interpretation" (1999) 85 Va. L. Rev. 1021–1023, documenting and advocating use of the technique.

both in public debate and in computerised systems of analysis: when a pattern of thought is unsuccessful, shift to a higher or lower level of generality.[96] If the parties are sufficiently skillful in manipulating the written law, the written law ultimately proves at least plausibly indeterminate.

Sophisticated lawyers argue the written law, but they anticipate its indeterminacy. Understanding that content must be injected into written law in every case, they ground their arguments in several non-doctrinal rationales. These include social norms, the law in action, the law in lawyers' heads, informal rules of factual inference, system imperatives, community expectations regarding outcomes, and public policy. Table 4.1 contains illustrations of each kind of argument.

These arguments do not purport to be based in law. They purport only to buttress the maker's argument that the written law, correctly interpreted, requires the desired conclusion: "The law favors our side, and this argument is proof of its wisdom and rationality in doing so." In actuality, arguments such as these are outcome-determinative. If both lawyers are competent, both sides will have sound arguments from legal doctrine. The side that is most persuasive with their indirect

Table 4.1

Argument from	Generalisation of the argument	Example of the argument
Social norms	This is the fair thing to do	"An employer can't fire an employee based solely on false accusations"
Law in action or legal outcomes	This is the result reached in like cases in the past	"The evidence shows that employees have never been given hearings in cases such as these"
Law in lawyers' heads	This is what the law requires	"The law is clear that, unless otherwise specified, employment is 'at will' and the employee can be discharged for any reason or for no reason"
Informal rules of factual inference	When fact A is present, fact B is present as well	"The defendant was late for an important meeting; so she was hurrying and therefore careless"[a]
System imperative	Absent this result, the system cannot operate as intended	"If this employee is entitled to a hearing, then so are the other 500,000 employees discharged each year"
Community expectations regarding outcomes	This result is in accord with commercial or community expectations	"Most employees would be shocked to learn that they could be fired on the basis of false accusations without being given the opportunity to present their side"
Public policy	This interpretation is in accord with the lawmakers' intention	"The reason for the rule is that . . ."

[a]See A.J. Moore et al., *Trial Advocacy*, (1996) 23–34, presenting this example

[96]See J.W. Singer, "The Player and the Cards: Nihilism and Legal Theory" (1984) 94 Yale L.J. 17, "Even if a specific rule exists that has no exceptions and that everyone agrees how to apply . . . there is always a more general rule or principle that could plausibly be used to nullify it . . . ."

arguments will almost always win. Through the process of interpretation, the sources in the first column of the table – spontaneously generated "private" law – are fused into and made the content of the rules of law promulgated by the state.[97]

Before a judge who believes legal doctrine determinate, the most effective response to each of the arguments in the table is to point out that the argument is grounded in something other than legal doctrine. For example, in response to the argument from social norms, opposing counsel might reply that "my opponent argues that social norms prohibit an employer from firing an employee for something the employee did not do. That may well be, but the law is to the contrary." Similarly, the best response to an argument that relies on informal factual inference is probably to point out precisely the basis on which the inference is being drawn. "My opponent argues that just because a person was late for a meeting, you should infer that the person was careless."

Normative content can be infused into otherwise empty legal rules even before any case arises. That is, even though the ultimate interpretation of a rule remains open as a technical or legal matter, if a consensus forms in the relevant legal community that a particular interpretation is "correct," other interpretations may, as a practical matter, be foreclosed. For example, when a new law is enacted, "experts" may promote a particular interpretation at judicial education or continuing legal education programs.[98] Even though the law is ambiguous on its face, once a consensus forms in the relevant legal community, individual judges may be under pressure to conform.

4.3.2 Strategies that Constrain Judges

At least four types of legal strategy exist for pressuring judges into a favourable resolution of a case without entirely persuading them to it: case selection, making a record, legal planning, and media spin.

4.3.2.1 Case Selection

In his landmark article, "Why the 'Haves' Come Out Ahead," Marc Galanter explained the many ways that "repeat players" – who were generally business interests – could tip the balance of law in their favour by selecting to litigate the

[97]See Weyrauch and Bell (n 14) 381, "Thus interpretation becomes a method by which private lawmaking and the printed rules of the state are fused."

[98]See Galanter, "Why the 'Haves' Come Out Ahead" (n 2) 103, referring to actions of repeat players as "secur[ing] the penetration of rules favorable to them"; according to W.O. Weyrauch, *The Personality of Lawyers* (Yale University Press, 1964) 230–231 [Weyrauch, *The Personality of Lawyers*], referring to corresponding practices in Germany.

cases most likely to make favourable law.[99] He advocated the development of counter-strategies in which organizations of otherwise "single-shot" players would do the same thing.[100]

To illustrate case selection as a legal strategy, assume that the manufacturer of a product is interested in establishing that its product is not unreasonably dangerous as a matter of law. Plaintiffs have filed cases in which this issue might be raised in half a dozen state or federal courts spread throughout the United States. The manufacturer begins by evaluating the six cases on a single criterion: if the plaintiff raises the issue of whether the product is unreasonably dangerous as a matter of law, what is the likelihood that the court will decide it in favour of the manufacturer? Assume that the likelihood of decision favourable to the manufacturer is 60% in each of two courts and 10% in the four others.[101] Assume also that the unfavourable courts are further along in processing the cases, so that their decisions are likely to be rendered first. Absent a case-selection strategy, the odds are nine-to-one that the first decision will go against the manufacturer. With that case argued as precedent,[102] whether binding or not,[103] the manufacturer's chances of winning the next three cases probably sink even lower. By the time the favourable courts reach the issue, the domino effect of precedent may already have put four decisions unfavourable to the manufacturer on the books. This "weight of authority," perhaps

[99]Galanter states: "Rule-development is shaped by a relatively autonomous learned tradition, by the impingement of intellectual currents from outside, by the preferences and prudence of the decision-makers. But courts are passive and these factors operate only when the process is triggered by parties. The point here is merely to note the superior opportunities of the [repeat player] to trigger promising cases and prevent the triggering of unpromising ones." Galanter, "Why the 'Haves' Come Out Ahead" (n 2) 103 (emphasis added). Macaulay made essentially the same point earlier in discussing the automobile manufacturers' strategy in opposition to the Good Faith Act. See S. Macaulay, *Law and The Balance of Power: The Automobile Manufacturers and their Dealers* (Russell Sage Foundation, 1966) 96–103 [Macaulay, *Law and the Balance of Power*].

[100]See Galanter, ibid 141, "The reform envisaged here is the organization of 'have not' parties . . . into coherent groups that have the ability to act in a coordinated fashion, play long-run strategies, benefit from high-grade legal services, and so forth."

[101]These differences may result from differences in the attitudes of decision-makers regarding the legal issue or from entirely extralegal matters such as the particularly appealing or unappealing nature of one of the parties.

[102]Even when a court does not publish an opinion in the process of deciding the case, parties who are aware of the decision are usually free to present the decision to a later court and argue that the later court should follow it. See W.M. Richman, and W.L. Reynolds, "Elitism, Expediency, and the New Certiorari: Requiem for the Learned Hand Tradition" (1996) 81 Cornell L. Rev. 286, "Even though they cannot cite unpublished opinions, repeat litigants . . . are able to catalog them and use their arguments. They also may request formal publication of those unpublished opinions that they believe will make favorable precedent"; See also K. Shuldberg, "Digital Influence: Technology and Unpublished Opinions in the Federal Courts of Appeals" (1997) 85 Cal. L. Rev. 569, noting that "[s]ix circuits currently allow citation [of unpublished opinions], up from only two circuits in 1994."

[103]Precedent set by a trial court typically would not bind a trial court in another district.

augmented by a "precedential cascade"[104] effect against the manufacturer's position, may persuade the two remaining courts to abandon their inclination in favour of the manufacturer.

The manufacturer could improve the odds of the case-law developing in its favour by assuring that the two courts favourable to the manufacturer[105] are the first to render decisions. The manufacturer could employ at least four tactics for accomplishing that result. First, it could settle or delay the four cases pending in adverse courts so that the courts did not decide them, or at least, did not decide them first. Second, it could permit the cases to go forward to jury verdicts, but without raising the issue of whether the product was unreasonably dangerous as a matter of law. Third, it could strike a bargain with the plaintiffs in the unfavourable courts that would tie the outcomes of their cases to the outcomes in the two favourable courts and delay the former until the latter were decided. The inducement might be the elimination of much of the cost of litigation, or the guarantee of a minimum recovery regardless of the outcome of the case. Lastly, after trying and losing the first cases, the manufacturer could enter into settlement agreements conditioned upon the court not publishing an opinion or upon the court sealing the file.[106] By assuring that the favourable courts decide first, the manufacturer puts favourable law on the books for use in arguing subsequent cases.

Though the strategy of case selection has been sufficiently effective to draw the attention of legal scholars, it remains relatively weak. Case selection is a means of generating written law favourable to one's position. However, litigation is unlikely to establish written law in any given case, and, as previously noted, even once established, written law is not very powerful.[107]

[104]E. Talley, "Precedential Cascades: An Appraisal" (1999) 73 S. Cal. L. Rev. 87, arguing that the spread of legal precedent may be augmented by a "cascade" effect that magnifies the significance of early decisions.

[105]Courts often indicate their intentions with regard to future rulings. In some cases, they do so formally, but in most it is only by their demeanour or their rulings on preliminary issues.

[106]See L. Kratky Doré, "Secrecy by Consent: The Use and Limits of Confidentiality in the Pursuit of Settlement" (1999) 74 Notre Dame L. Rev. 390–395, discussing the sealing of court records pursuant to settlement agreements; See also M.J. Dragich, "Will the Federal Courts of Appeals Perish If They Publish? Or Does the Declining Use of Opinions to Explain and Justify Judicial Decisions Pose a Greater Threat?" (1995) 44 Am. U. L. Rev. 764–765, discussing the practice of vacating published opinions when requested by the parties upon later settlement of the case; See also J.E. Fisch, "Rewriting History: The Propriety of Eradicating Prior Decisional Law Through Settlement and Vacatur" (1991) 76 Cornell L. Rev. 596, discussing the benefits to the unsuccessful litigant who then negotiates a settlement with her adversary to request the court to vacate the judgment.

[107]See for example, Galanter, "Why the 'Haves' Come Out Ahead" (n 2) 149–150, observing that "[t]he system has the capacity to change a great deal at the level of rules without corresponding changes in everyday patterns of practice or distribution of tangible advantages."

4.3.2.2 Making a Record

Appellate courts decide cases on the record and the written and oral arguments of counsel. The record consists of selected portions of the pleadings and other documents filed in the case, transcripts of what transpired orally, and evidence offered. The appellate court may reverse the decision because the court below decided it wrongly or because the lower court did not follow appropriate procedures, as indicated by the record.

When litigating a case, the lawyers generally have an incentive to "make a record" favourable to their own position. The record may be useful in overturning an adverse decision on appeal, or defending a favourable one.

Strategic opportunities abound. To maximise the possibility of reversal on appeal, the lawyer may make frequent objections, may attempt to incite the judge to intemperate action,[108] may proffer evidence or testimony of questionable admissibility, or may argue positions ineffectually in the hope of leading the court into reversible error.

Appellate courts assume that the judges below had legally acceptable reasons for their decisions unless the records affirmatively show that they did not.[109]

For that reason, a judge who does not wish to be reversed on appeal is best advised to give no more explanation than is legally required.[110] That is what most judges do. The task of a lawyer-strategist who seeks reversal, is to get the judge to articulate an unacceptable reason for the decision. The lawyer might do that by directly asking the reasons for the ruling, or by accusing the judge of employing a particular line of reasoning, thereby provoking a response.[111] Alternatively, the lawyer might make a series of motions or proffers that, when ruled upon, eliminate particular lines of reasoning as possible explanations for the overall decision.[112]

For present purposes, the key is to understand that these strategies are not meant to persuade the trial judge – or in many instances the appellate judge either – to the

[108]See for example, *United States v. LeFevour*, (1986) 798 F.2d 977, 985 (7th Cir.), "The tactic of a lawyer in a losing cause who tries to provoke the trial judge into error is an old one, well exhibited by LeFevour's counsel, who was twice held in contempt in the course of the trial"; T. Carter, "Playing Hardball at Microsoft: Chief Counsel William Neukom is Leading a Legal Charge that Verges on Either the Risky or Brilliant or Both" A.B.A. J., (Aug. 1998) 24–25, speculating that the attorney for Microsoft may have been attempting "to provoke the judge into appealable error."

[109]See for example, *Marvin v. Marvin*, (1996) 557 P.2d 111–116 (Cal. Ct. App.), considering defendant appellee's four theories for sustaining the court's order of dismissal in a case where the court gave no reason for its ruling.

[110]See Fed. R. Civ. P. 52(a), requiring federal judges to make findings of fact in cases tried without juries.

[111]See for example, *United States v. Hartford*, (1974) 489 F.2d 655–656 (5th Cir.), describing an instance in which one of the authors of this Article successfully employed this strategy.

[112]See for example, *Dynes v. Dynes*, (1994) 637 N.E.2d 1324 (Ind. Ct. App.), holding that the trial court's rejection of proffered evidence of a witness's reputation for dishonesty fatally undermined the court's findings of fact, which were based solely on that witness's testimony.

lawyer's position. The goal may be to intimidate the trial judge or to make sure that the case is decided on ancillary issues in the appellate court. Although reversal on ancillary issues is not automatically victory, it can get the lawyer a "second bite at the apple" – another trial at another time, in different circumstances, and perhaps with a different trial judge – and is also highly likely to lead to settlement.[113]

4.3.2.3 Legal Planning

The term "legal planning" is used broadly to refer to action taken before contemplated litigation in an attempt to establish what will become the facts of that litigation.[114] Professor Leo Katz provides the following examples of particularly strategic legal planning:

> (3) A lawyer suggests to a client who owns a farm that she incorporate the farm and declare herself its employee in order to qualify for social security . . . (5) A lawyer recommends to elderly clients that they distribute their assets to their children so that they qualify for governmental assistance more quickly. (6)
>
> A lawyer recommends that a client turn most of its employees into independent contractors to escape the burden of social security taxes or even simple tort liability.[115]

The planner may conceive of his or her purpose as avoiding litigation,[116] but the plan typically accomplishes that only by assuring that, in the event of litigation, the planner's side would win.

The strategies Katz suggests consist of creating fact patterns that satisfy the antecedents of legal rules, and thus achieving the desired results. However, as we have seen, legal rules are not, in and of themselves, of much effect. For virtually any legal rule that would achieve the planner's objectives, there is another rule or doctrine that could be used to attack it. Corporate veils can be pierced; security interests can be subordinated; contracts can be rescinded, reformed or invalidated; and conveyances can be avoided. At a minimum, such planning is always vulnerable to attack as a "sham" or a "subterfuge."[117]

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[113]See D.F. Pike, "Retrials: A Bad Case of Deja Vu" Nat'l L.J., (31 Aug. 1981) 1, 27, noting that "retrials are relatively rare" and explaining the reasons.

[114]Professor Galanter refers to it as "restructur[ing] the transaction to escape the thrust of the . . . rule." Galanter, "Why the 'Haves' Come Out Ahead" (n 2) 149.

[115]Katz (n 7) 566.

[116]See for example, L.M. Brown, and E.A. Dauer, *Planning By Lawyers: Materials on a Non-adversarial Legal Process* (Foundation Press, 1978) xix, "As contrasted with dispute-resolving law, preventive law . . . deals with the avoidance of dispute, and with the structuring of relations and transactions apart from any extant dispute."

[117]See for example, *Lubrizol Corp. v. Cardinal Constr. Co*., (1989) 868 F.2d 769 (5th Cir.), noting that the various names given to the cause of action that seeks to hold one corporation liable for the acts of another, including "sham corporation," are not analytically helpful and instead "cloud the thinking of lawyers and judges."

The sophisticated planner realises that norms, customs, system imperatives, expectations regarding outcomes, and other informal bases for decision-making likely will be determinative. Accordingly, sophisticated planning will proceed largely on the basis of appearances. To illustrate the difference, consider the circumstances of a debtor who expects to file bankruptcy soon and wishes to keep as much property as possible. Mere attention to legal doctrine might suggest that the debtor convert all of the debtor's assets to exempt property, leaving it to the court to determine which of the conversions were made with fraudulent intent. But the strategist who took a broader view would realise that the greed and lack of consideration evidenced by that strategy would likely turn the court against the debtor. Bankruptcy lawyers express this truth in the familiar aphorism that "pigs get fat, hogs get slaughtered."[118] Similarly, if the law exempts an automobile of a specified value, the doctrinalist might assume that the model and colour were irrelevant.[119] The sophisticated strategist, by contrast, would immediately recognise the difference between purchasing a staid blue Chevy Caprice and a flashy red Corvette – even if the dollar amounts of the two purchases were identical.[120]

Legal planning is often an effort to persuade rather than constrain the court. Judges are to some degree politicians. Even those with lifetime appointments often seek higher offices or professional acclaim. To those ends, they seek low rates of reversal and reputations for sound, responsible decision-making. Despite the lack of any doctrinally recognised difference between a Corvette and a Caprice, the former projects an image of extravagance and privilege that most observers would consider to be inappropriate for a person who is discharging debts in bankruptcy. The latter projects an image of practical necessity that fits more comfortably with bankruptcy discharge. A judge is therefore more likely to suffer criticism for permitting a debtor to retain a Corvette than a Caprice of the same dollar value.

4.3.2.4 Media Spin

Because judges care what members of the profession and the public think of them, they are vulnerable to media spin regarding the cases that come before them. To release a defendant who was probably guilty of the crime charged because the police violated the defendant's rights is a great deal more difficult when the crime is a heinous one that has caught the press's attention. For that very reason, the prosecutor who wants to win the case has an incentive to make sure the crime

[118]See for example, T.J. Zywicki, "Rewrite the Bankruptcy Laws, Not the Scriptures: Protecting a Bankruptcy Debtor's Right to Tithe" (1998) Wis. L. Rev. 1264, n. 170, quoting the popular aphorism in the context of bankruptcy exemption planning.

[119]See Llewellyn, *The Bramble Bush* (n 1) 48, discussing the relevance of model and colour of an automobile in a negligence hypothetical.

[120]See D.B. Bogart, "Liability of Directors of Chapter 11 Debtors in Possession: 'Don't Look Back – Something May Be Gaining On You'" (1994) 68 Am. Bankr. L.J. 190, n. 189, stating that "[i]t is often the attempt to extract the last dime of illegal profit that raises creditor and court ire."

catches the attention of the press. F. Lee Bailey, a highly successful trial lawyer in the 1960s and 1970s, was notorious for arguing his cases in the press, thereby "seeking to create a force outside the courts with the expectation and intention that the force so created would produce a desired result in a particular case within the courts."[121] Since Bailey's heyday, the standards for what is acceptable have been liberalised.[122]

For the past two decades, manufacturers and insurers have been campaigning in the mass media against high jury verdicts and expanded remedies.[123] Ironically, the campaign seems to have had more effect on judges than on jurors. Recent studies show astonishingly high rates of verdict reductions or reversals by both trial and appellate courts.[124]

4.3.3 Strategies that Transcend Judges

The most interesting types of strategies are those that seek a particular result "in spite, if you please, of what the judges in a case of dispute may be expected to do."[125] These are legal strategies that seek to prevent the other side from obtaining an adjudication or that seek to control who the adjudicator will be.

[121] *In re Bailey*, (1971) 273 A.2d 566–567 (N.J.) (internal quotation marks omitted). In fact, as a result of disciplinary proceedings arising from Bailey's penchant for publicising cases, he was suspended from practicing pro hoc vice in New Jersey for a period of 1 year.

[122] See for example, *Gentile v. State Bar of Nev*., (1991) 501 U.S. 1043 (Kennedy, J., plurality opinion), "An attorney's duties do not begin inside the courtroom door . . . [A]n attorney may take reasonable steps to defend a client's reputation and reduce the adverse consequences of indictment . . . including an attempt to demonstrate in the court of public opinion that the client does not deserve to be tried"; R.L. Shapiro, "For the Defense" (1996) 30 Loy. L.A. L. Rev. 109, "Most sophisticated city and county prosecutorial offices now have professional public relations personnel to manage press coverage and disseminate information about an ongoing case."

[123] See M. Galanter, "An Oil Strike in Hell: Contemporary Legends About the Civil Justice System" (1998) 40 Ariz. L. Rev. 747 (1998), discussing "corporate investment in projecting an image of unrestrained litigiousness and rampant overclaiming" and its "paradoxical effect of increasing the level of claiming"; See also W. Glaberson, "Some Plaintiffs Losing Out in Texas' War on Lawsuits" N.Y. Times, (7 June 1999) A1, describing the campaign against plaintiffs' verdicts in Texas.

[124] See K.M. Clermont, and T. Eisenberg, "Appeal from Jury or Judge Trial: Defendants' Advantage" (4 May 1999) 4 (unpublished, on file with the Duke Law Journal); See also M. Cronin Fisk, "Now You See It, Now You Don't" Nat'l L.J., (28 Sept. 1998) C1, discussing a study of 100 representative large verdicts of $1 million or more in 1994, about two-thirds of which were reduced or set aside.

[125] Llewellyn, *The Bramble Bush* (n 1) 14.

4.3.3.1 Cost Strategies

Legal remedies are available only through litigation.[126] Litigation is expensive and can be made more so by the manner in which it is conducted. For example, by expanding the issues in litigation, a party can expand the scope of discovery or the opportunity to employ experts. Depositions may be taken in geographically remote areas, putting the opposing party to the expense of attending.

Retention of experts by one party ordinarily necessitates the retention of other experts by the opposing party.[127] As a result, it may cost millions of dollars in out-of-pocket costs for plaintiffs to prepare for trial a simple dispute over the dumping of toxic chemicals caused a cluster of children's leukemia.[128] Occasionally, a party is able to win a case by exhausting the other side's resources, or to prevent the bringing of a case by eliminating the other side's resources,[129] though the more common result is settlement of such a case at a discount.[130]

A manufacturer's or seller's announcement that it will defend all cases to final decisions by the courts, without consideration of settlement, can, in some situations, dramatically reduce the number of cases that are cost-effective to litigate.[131] For example, the cigarette companies "decided they would defend every claim, no matter what the cost, through trial and any possible appeals" and held to that policy for 35 years.[132] The strategy was phenomenally successful. At the end of those 35 years, few cases had come to trial, and the companies had not paid out a cent in tort awards.[133]

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[126]That is, courts do not grant remedies or enter orders in the absence of a case filed by some party.

[127]See for example, K. Donovan, "Squirm Time for Milberg Weiss" Nat'l L.J., (5 Apr. 1999) A1, quoting class-action lawyer Melvyn I. Weiss, a frequent user of expert witnesses, to the effect that "[e]xpert witnesses neutralize each other." The experts testify regarding issues of fact, issues of foreign law, and increasingly, issues of domestic law. See for example, *Bookhardt v. State*, (1998) 710 So. 2d 700 (Fla. Dist. Ct. App.), permitting expert testimony on legal meaning of the term "security"; For further discussion see, Note, "Expert Legal Testimony" (1984) 97 Harv. L. Rev. 797, arguing that courts do, and should, ignore the prohibition on expert legal testimony.

[128]See for example, Harr (n 9), describing the great trial-preparation costs to plaintiffs in the Woburn, Massachusetts, suit alleging harmful effects of a leak from a toxic dump into drinking water supplies.

[129]See for example, *Southern Christian Leadership Conference v. Superior Ct. of La.*, (1999) 61 F. Supp. 2d 499 (E.D. La.), upholding the state and federal constitutionality of the Louisiana business community's decision to dismantle the Tulane Environmental Law Clinic to prevent the bringing of certain kinds of cases.

[130]See Harr (n 9) 405–448, describing cost pressures toward settlement in a complex environmental case.

[131]This would be a cost-effective strategy where the increased costs of litigating every case are outweighed by the savings from not having to defend or pay settlements in cases where the strategy discourages plaintiffs from pursing their claims.

[132]R.L. Rabin, "A Sociolegal History of the Tobacco Tort Litigation" (1992) 44 Stan. L. Rev. 857.

[133]Ibid 874, "Thus, after thirty-five years of litigation, the tobacco industry could still maintain the notable claim that it had not paid out a cent in tort awards."

4.3.3.2 Delay Strategies

Litigation takes time, and defendants can expand the amount required by the manner in which they respond.[134]

An award of the same relief at a later time may be less valuable to the plaintiff or less costly to the defendant.[135] For example, if the court delays the entry of an order barring a competitor's illegal practices, the competitor may succeed in driving the plaintiff out of business in the interim. Damages may not be an adequate substitute, because the damages actually incurred might be too speculative to recover[136] or the judgment for those damages might not be collectible.[137]

Delay may reduce the expected value of a lawsuit by reducing the plaintiff's chances of winning. Witnesses may die or disappear. Evidence may be altered or destroyed. The pattern of judicial or community attitudes that made the case worth bringing may change. The damage inflicted on the plaintiff by the defendant's wrongful act may become less poignant with the passage of time – perhaps through the death of the plaintiff. The plaintiff may become discouraged by the passage of time, or become less determined or less able to devote the necessary resources.

Delay may also reduce the plaintiff's chances of collecting any money judgment that may be rendered; that is, a defendant that is not judgment-proof at the commencement of litigation may become judgment-proof by its conclusion.[138] The defendant may even be able to delay until the case becomes moot.[139] When cases settle, the amounts of the settlements are likely to be discounted for the time, expense, and uncertainty that would have been involved in completing the litigation.

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[134]See D.E. Rovella, "High-profile Conn. Lawyer Disappears" Nat'l L.J., (22 Mar. 1999) A19, noting that "[f]ellow stars of the Connecticut defense bar were unequivocal in their admiration for [attorney] Francis Mac Buckley . . . His capacity to delay cases, it is said, is legendary."

[135]See for example, J.K. Van Patten, and R.E. Willard, "The Limits of Advocacy: A Proposal for the Tort of Malicious Defense in Civil Litigation" (1984) 35 Hastings L.J. 893, n. 9, suggesting situations in which a defendant can benefit from a meritless appeal by earning sufficient interest on the plaintiff's judgment to cover the costs of the appeal and earn a margin of profit.

[136]See for example, *Kidder, Peabody & Co. v. IAG Int'l Acceptance Group, N.V.*, (1998) 28 F. Supp. 2d 131 (S.D.N.Y.), "While lost profits need not be established with 'mathematical precision,' they must be 'capable of measurement based upon known reliable factors without undue speculation.'" (quoting *Ashland Mgt. Inc. v. Janien*, (1993) 82 N.Y.2d 395, 403.

[137]See for example, L.M. LoPucki, "The Death of Liability" (1996) 106 Yale L.J. 1, 14–38 [LoPucki, "The Death of Liability"], describing strategies by which a defendant can protect its assets so as to render itself "judgment-proof."

[138]As a general rule, without a judgment from a court, a creditor cannot interfere with a debtor's use of its property. See *Grupo Mexicano de Desarrollo, S.A. v. Alliance Bond Fund, Inc.*, (1999) 527 U.S. 333, holding that because of this general rule, in the instant case, "the District Court had no authority to issue a preliminary injunction preventing [debtor] petitioners from disposing of their assets pending adjudication of the [creditor] respondents' contract claim for damages."

[139]See for example, *Board of Sch. Comm'rs v. Jacobs*, (1975) 420 U.S. 130, holding that a case brought by six high school students for interference with their First Amendment rights with respect to a school newspaper was moot because the students had graduated by the time the case reached the Supreme Court.

The fact that delay affects case outcomes is widely recognised. What is not widely recognised is the capacity of legal strategy to manipulate the extent of delay.[140] Strategies that can change the extent of delay can change both the parties' chances of winning and the amounts by which their cases will be discounted in early settlements.

Various rules of law may seem to prohibit strategies that seek delay, but, on close examination, they prove ambiguous. Thus, for example, the ABA Model Rules of Professional Conduct impose on lawyers an obligation to "make reasonable efforts to expedite litigation" but only "consistent with the interests of the client."[141] The comment to that rule provides that "[d]elay should not be indulged merely for the convenience of the advocates, or for the purpose of frustrating an opposing party's attempt to obtain rightful redress or repose."[142] The term "merely" suggests that deliberate delay is acceptable strategy when those motives coincide with loftier ones, even if the loftier ones are of little weight in the decision. Rule 11 of the Federal Rules of Civil Procedure refers to "unnecessary delay" as an "improper purpose,"[143] suggesting that delay is a proper purpose when the delay is "necessary." The effect of these ambiguities is to provide the basis for an array of strategies that lawyers can use to pursue, or counter, delaying strategies.

4.3.3.3 Extralegal Strategies

Much strategic effort is devoted to extralegal means of deterring those entitled to legal remedies from suing or from continuing suits already filed. These efforts range from common courtesy – an airline's making relatives comfortable and providing them with information in the days immediately following a fatal crash – to physical violence. Between those extremes are a variety of pressures that parties to a litigable dispute can apply against their opponents. One can embarrass an opponent by the kinds of questions asked in trial or in deposition, or by the nature of the matters inquired into in discovery. One can make an opponent's life unpleasant by conducting litigation in an uncivil manner. One can threaten an opponent – perhaps explicitly, but more likely implicitly – with the loss of business

[140]See for example, Galanter, "Why the 'Haves' Come Out Ahead" (n 2) 121, treating delay as merely the product of institutional overload; See also (n 2) 139, suggesting that an "increase in institutional facilities for processing claims" would be sufficient to eliminate delay. Rule 3.2 of the Model Rules of Professional Conduct misses the legal strategy point when it states that "[a] lawyer shall make reasonable efforts to expedite litigation consistent with the interests of the client." Model Rules of Professional Conduct Rule 3.2 (1999) (emphasis added). Read literally, the rule authorises every delaying tactic that benefits the client because elimination of that delay would be inconsistent with the interests of the client.

[141]Model Rules of Professional Conduct ibid.

[142]Ibid cmt. 1.

[143]Fed. R. Civ. P. 11.

relationships, unwanted publicity, the loss of a job, criminal prosecution,[144] deportation,[145] or embarrassment in matters having no direct relationship to the litigation, or, one can go entirely outside the law, fabricating evidence, bribing judges,[146] or murdering witnesses.[147]

The effect of these extralegal strategies on patterns of litigation is difficult to overestimate. Businesses tend to sue their trading partners only when the business relationship expires.[148] A recent empirical study found that only one in 50 patients with a valid claim for malpractice against a medical provider actually made the claim.[149] Cases against professional killers or other violent felons are notoriously difficult to bring because witnesses understandably fear for their lives.[150]

[144]See ABA Comm. on Ethics and Professional Responsibility, (1992) Formal Opinion 92-363, finding that "[t]he Model Rules do not prohibit a lawyer from using the possibility of presenting criminal charges against the opposing party in a private civil matter to gain relief for a client, provided that the criminal matter is related to the client's civil claim." Statutes in some states may, nevertheless, prohibit the practice.

[145]For example, illegal aliens may have difficulty in claiming their legal rights because they fear that the opposing party will discover their status and bring it to the attention of the immigration authorities. See for example, H.A. Freeman, and H. Weihofen, *Clinical Law Training: Interviewing and Counseling* (West Publishing Co., 1972) 208–209, summarising a divorce case in which the husband used threats of deportation to discourage his Canadian wife from asserting her rights in the divorce proceedings.

[146]The bribery of judges has been a recurring problem in the American legal system. See for example, *United States v. Maloney*, (1995) 71 F.3d 665 (7th Cir.), affirming a Chicago judge's conviction for accepting bribes in murder cases; "2 Judges Guilty in Florida Corruption Inquiry" N.Y. Times, (28 Apr. 1993) A18, reporting the conviction of two Dade County, Florida, judges for bribery.

[147]See for example, R.J. Harris, "Whither the Witness? The Federal Government's Special Duty of Protection in Criminal Proceedings After Piechowicz v. United States" (1991) 76 Cornell L. Rev. 1302–1303, discussing the problem of protecting witnesses in criminal cases and proposing a duty for the government to protect federal criminal witnesses who are threatened, based, *inter alia*, on knowledge or reasonable foreseeability that the witness is in danger.

[148]See T.V. Lee, "Risky Business: Courts, Culture, and the Marketplace" (1996) 47 U. Miami L. Rev. 1409, "Litigation makes sense only if merchants expect to profit beyond the breakdown of the business relationship"; See also S. Macaulay, "Non-Contractual Relations In Business: A Preliminary Study" (1963) 28 Am. Soc. Rev. 61–62, finding that parties in long-term business relationships litigate only when reputational sanctions fail, usually in situations involving high stakes or the termination of the relationship; See also Macaulay, *Law and the Balance of Power* (n 100) xv, "Once their franchises have been terminated, [automobile dealers] have been willing to sue." Professor Galanter notes that "the more inclusive in life-space and temporal span a relationship between parties, the less likely it is that those parties will resort to the official system." See Galanter, "Why the 'Haves' Come Out Ahead" (n 2) 130 (footnotes omitted).

[149]See P.C. Weiler et al., *A Measure of Malpractice: Medical Injury, Malpractice Litigation, and Patient Compensation* (Harvard University Press, 1993) 73, describing a hospital review where only 8 out of 280 patients with "identifiable negligent injury" actually filed claims.

[150]See J.C. Jeffries, and J. Gleeson, "The Federalization of Organized Crime: Advantages of Federal Prosecution" (1995) 46 Hastings L.J. 1113, "Most civilian witnesses in organized crime investigations – extortion victims, relatives of murder victims, and chance eyewitnesses – are extremely reluctant to testify. Often they refuse to do so even in the secrecy of the grand jury."

4.3.3.4 Contractual Strategies

Through a variety of contracts, legal strategists can install their allies as decision-makers, bar the bringing of otherwise meritorious cases, or shift risks to persons who do not realise their magnitude. Examples of the first are contracts that require arbitration of customer claims against industry by arbitrators whose primary loyalty is likely to be to the industry.[151]

Examples of the second are contracts in which customers waive their right to sue the businesses they patronise. An example of the third is an agreement in which the customer indemnifies the company against claims by third parties.[152]

In most of these circumstances, the strategy is both contemplated and authorised by legal doctrine. That is, policymakers have made a deliberate choice to permit customers to waive their rights. But legal strategy is capable of extending these contracts and waivers beyond the limits contemplated or authorised. For example, Professor Katherine Van Wezel Stone documents how legal strategists for industry have transformed the *Federal Arbitration Act* from a guarantor of a level playing field to a tool for the oppression of employees or customers.[153]

4.3.3.5 Forum Shopping

Given what we have already said about the ineffectiveness of legal doctrine, the fact that different decision-makers reach different results on the same legal doctrine should not be surprising.[154]

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[151]See K. Van Wezel Stone, "Rustic Justice: Community and Coercion Under the Federal Arbitration Act" (1999) 77 N.C. L. Rev. 936–939 [Van Wezel Stone], describing a hypothetical case where a consumer purchases a computer through an advertisement and finds inside the box a binding contract that includes the requirement that all claims be arbitrated "in Phoenix, Arizona before a panel of three retired industry executives"; But see United States General Accounting Office, *Securities Arbitration: How Investors Fare* (1992) 35–39, finding securities investors no more likely to prevail in an "independent" forum, such as the American Arbitration Association, than in industry-sponsored forums such as the New York Stock Exchange or the National Association of Securities Dealers.

[152]See for example, *United Servs. Automobile Ass'n v. Snappy Car Rental, Inc*., (1999) 87 Cal. Rptr. 2d 743 (Cal. Ct. App.), analysing a car rental contract under which a consumer renter indemnified a car rental company against claims of third parties arising out of use of the automobile; See also Microsoft Indemnification requiring that the customer indemnify the provider against litigation arising out of the customer's usage of the internet (on file with the Duke Law Journal) [Indemnification], online: Indemnification http://memberservices.msn.com/gettingstarted/guidelines/memberagreement.htm#Section12.

[153]See Van Wezel Stone (n 152) 938–941, lamenting that a contract to arbitrate in an unusual forum with a panel chosen by industry could be enforceable even though the contract – found inside the package after it was purchased – made no mention of arbitration, referring only to "the rules and regulations of the Computer Manufacturer's Industry Trade Association."

[154]See for example, T. Eisenberg, and L.M. LoPucki, "Shopping for Judges: An Empirical Analysis of Venue Choice in Large Chapter 11 Reorganizations" (1999) 84 Cornell L. Rev. 967

To take advantage of those differences, legal strategists have devised numerous ways of controlling who will decide a dispute. In some circumstances, legal doctrine deliberately affords the party filing the case a choice among courts[155] or even among judges of a single court.[156] The most prominent example is the right of a plaintiff to sue a defendant in any jurisdiction in which the defendant does business.[157] Most plaintiffs so entitled use their "venue privilege" to bring their actions in the jurisdiction most convenient for them. But some choose the jurisdiction for the likelihood that its courts will rule in their favour.[158]

The doctrines that initially afford plaintiffs choices among courts may also give opposing parties means of upsetting the plaintiffs' choices, leading to an interaction of strategies. For example, if the plaintiff files a case against an out-of-state defendant, the defendant may have the right to remove the case to the federal court.[159] Plaintiffs who anticipate the possibility of removal may be able to prevent it by joining additional defendants,[160] by suing only on state law causes of

[Eisenberg and LoPucki, "Shopping for Judges"], analysing rampant forum shopping in cases under the United States Bankruptcy Code; See also E. Flynn, "Confirmation Rates By Judge" (1998) 1989–1996 (unpublished, on file with the Duke Law Journal), showing five U.S. Bankruptcy judges as confirming reorganization plans in fewer than 10% of their cases and six confirming plans in more than 50% of their cases. Some portion of the difference in the confirmation rates reported by Flynn may be attributable to differences in types of cases assigned to the judges, but the differences are too great to be entirely accounted for by that factor.

[155]For example, in Florida, most civil suits may be filed "in the county where the defendant resides," or "in the county where the cause of action accrued." Fla. Stat. Ann. § 47.011 (West 1994). Some actions can be filed in state court or federal court. See for example, 20 Am. Jur. 2d Courts § 97 (1995), "[I]n diversity of citizenship cases, the jurisdiction of federal courts is concurrent with that of state courts, provided the amount involved meets the minimum specified by Congress for an action to be brought in a federal court."

[156]For example, Wisconsin and California statutes give each party to the case the option to remove one judge. See Cal. Civ. Pro. Code Ann. § 170.6 (West Supp. 2000), providing for substitution of judges based on an affidavit that the judge is prejudiced against any party or attorney.

[157]See B.G. George, "In Search of General Jurisdiction" (1990) 64 Tul. L. Rev. 1108–1119, describing the legal basis for jurisdiction over causes of action that did not arise out of the defendant's activities in the forum.

[158]See for example, D.W. Robertson, "The Federal Doctrine of Forum Non Conveniens: 'An Object Lesson in Uncontrolled Discretion'" (1994) 29 Tex. Int'l L.J. 354–355, quoting Lord Denning's description of how numerous cases involving injuries suffered on North Sea oil rigs were filed in Texas due to the possibility of larger verdicts in the United States than overseas.

[159]See 28 U.S.C. §1441(b) (1994), authorising removal "if none of the parties in interest properly joined and served as defendants is a citizen of the State in which such action is brought."

[160]See E. Chemerinsky, "Rationalizing Jurisdiction" (1992) 41 Emory L.J. 7, "[A] plaintiff trying to avoid removal to federal court might add defendants who are from the same state"; A.B. Rubin, "Hazards of a Civilian Venturer in a Federal Court: Travel and Travail on the Erie Railroad" (1988) 48 La. L. Rev. 1374–1375, "Plaintiffs who wish to avoid removal to federal court may do so if they can join, in addition to the non-resident defendant, a resident defendant, thus avoiding the complete diversity of citizenship that is a prerequisite to federal court jurisdiction." The doctrinal limit on this strategy is that the joinder cannot be "fraudulent." See *Marble v. American Gen. Life and Accident Ins. Co.*, (1998) 996 F. Supp. 573 (N.D. Miss.), quoting *Rodriguez v. Sabatino*, (1997) 120 F.3d 589, 591 (5th Cir.): "To prove that non-diverse parties have been fraudulently

action,[161] by requesting particular relief,[162] by suing in the defendant's home state,[163] or by otherwise destroying diversity.[164] Defendants who fear adjudication by a state or federal trial court can sometimes avoid it by filing for bankruptcy and having the initial adjudication made by the bankruptcy court as a determination of the amount of the plaintiff's claim.[165]

With respect to some types of actions, the party who would otherwise be the defendant can file first, thereby seizing the venue privilege for itself. These actions include divorces,[166] bankruptcies,[167] and virtually any matter that can be the subject of an action for declaratory relief.[168] Parties with bargaining leverage may attempt

joined in order to defeat diversity, the removing party must demonstrate either 'outright fraud in the plaintiff's recitation of jurisdictional facts,' or that 'there is absolutely no possibility that the plaintiff will be able to establish a cause of action against the in-state defendant in state court.'"

[161]See for example, *Caterpillar, Inc. v. Williams*, (1986) 482 U.S. 392, noting that a plaintiff is "the master of the claim" and may choose to avoid removal by omitting federal law claims from the initial complaint.

[162]See for example, *St. Paul Mercury Indem. Co. v. Red Cab Co.*, (1937) 303 U.S. 294, "If [the plaintiff] does not desire to try his case in the federal court he may resort to the expedient of suing for less than the jurisdictional amount, and though he would be justly entitled to more, the defendant cannot remove"; But see *De Aguilar v. Boeing Co.*, (1995) 47 F.3d 1410 (5th Cir.), "The inquiry, however, does not end merely because the plaintiff alleges damages below the threshold. The face of the plaintiff's pleading will not control if made in bad faith."

[163]See J.T. Molot, "How U.S. Procedure Skews Tort Law Incentives" (1997) 73 Ind. L.J. 73, n. 55, "A plaintiff can always avoid removal on diversity grounds, however, by filing a suit in the defendant's home state."

[164]See for example, *Mecom v. Fitzsimmons Drilling Co.*, (1931) 284 U.S. 188–190, allowing an Oklahoma administratrix to resign and a Louisiana administrator to be appointed to destroy diversity so an action could be brought in Louisiana.

[165]See for example, *In re Apex Oil Co.*, (1988) 91 B.R. 865 (Bankr. E.D. Mo.), assuming jurisdiction to estimate the Department of Energy's claims against a debtor over the Department's objections.

[166]See for example, *Martin v. Fuqua*, (1976) 539 S.W.2d 315–316 (Ky.), holding that where a husband and wife filed divorce actions in different counties, only the first case filed should proceed.

[167]The first court in which a bankruptcy case is filed by or against a particular debtor controls venue. See Bankr. Rule 1014(b), 11 U.S.C. app. (1994). In preparation for filing bankruptcy in New York, Baldwin-United, a Cincinnati company, established a New York headquarters. Creditors filed an involuntary case in Cincinnati just minutes before Baldwin-United filed its New York case. Unlikely to win the venue fight, and apparently fearful of offending the Cincinnati judge, Baldwin-United dismissed its New York filing without a fight. See L.M. LoPucki and W.C. Whitford, "Venue Choice and Forum Shopping in the Bankruptcy Reorganization of Large, Publicly Held Companies" (1991) Wis. L. Rev. 28, n. 60 [LoPucki and Whitford, "Venue Choice and Forum Shopping"].

[168]See for example, *League of Latin Am. Citizens v. Clements*, (1993) 986 F.2d 769 (5th Cir.), noting that, under Texas rules on venue, "a party who anticipates being sued may 'capture' venue by filing suit first" (citation omitted).

to control the venue through a contract provision imposed at the time of the initial transaction.[169]

The system's response to these kinds of strategies is to pass or create laws, such as the doctrine of forum non conveniens,[170] that authorise judges to transfer cases. But these laws fall far short of providing an antidote to forum shopping for legal outcomes. First, these laws do not even theoretically contemplate a single, most appropriate venue for each case. Second, in at least some contexts, practical and political pressures on judges have caused a general failure in the venue correction process.[171] Internationally, no correction mechanism may exist at all.[172] Empirical studies suggest that the struggle over venue is often outcome-determinative.[173]

Forum shopping among the judges of a single court is generally prohibited, and violations are usually treated as serious violations of legal ethics.[174] The predictable differences in legal outcomes across judges are, however, so great that legal strategists continue to find ways of picking their judges. The simplest means is to file the case in a court that has only a single judge,[175] or in a court that will advise

[169]See for example, *Carnival Cruise Lines, Inc. v. Shute*, (1991) 499 U.S. 595, upholding a contract provision providing for venue in Miami, Florida, for a Washington plaintiff injured on a cruise between Los Angeles and Puerto Vallarta, Mexico. Similarly, Microsoft's contract of adhesion for Internet access provides for venue in King's County, Washington, for all actions arising out of the customer's relationship with Microsoft. See Indemnification (n 153).

[170]See 28 U.S.C. § 1404(a) (1994), authorising a district court to change venue "[f]or the convenience of parties and witnesses"; *In re Union Carbide Corp*., (1987) 809 F.2d 202–203 (2d Cir.), upholding a dismissal due to forum non conveniens where the incident occurred in India, all plaintiffs were Indian citizens, and "the proof bearing on the issues to be tried [was] almost entirely located in India."

[171]See for example, Eisenberg and LoPucki, "Shopping for Judges" (n 155) 968, finding, based on an empirical study, that forum shopping was rampant in the bankruptcies of large, public companies from 1980 to 1997; See also ibid 1000, concluding that venue correction occurred in only about 5% of those cases; See also LoPucki and Whitford, "Venue Choice and Forum Shopping" (n 168) 24–26, describing forum shopping in specific cases.

[172]See for example, L.P. Cohen, "Frankel May Surrender, as a Deal Is Expected" Wall St. J., (1 July 1999) C1, noting that Samuel D. Sheinbein, accused of murder in the United States, successfully defeated United States venue for his murder trial by obtaining Israeli citizenship based on the fact that his father was born in the territory that became Israel.

[173]See generally K.M. Clermont, and T. Eisenberg, "Exorcising the Evil of Forum Shopping" (1995) 80 Cornell L. Rev. 1507, reporting that federal court plaintiffs lose a significantly larger percentage of transferred cases than they lose of all cases.

[174]See for example, "No Judge-Shopping Allowed" Nat'l L.J., (5 May 1997) A8, reporting that an attorney paid sanctions of $7,500 for filing 13 lawsuits, then withdrawing all but one in a case involving Dr. Jack Kevorkian; See also R. Samborn, "Chicago Judge Sanctions Firm" Nat'l L.J., (18 Apr. 1994) A4 [Samborn], reporting that a judge sanctioned Mayer, Brown & Platt lawyers for filing five identical complaints in an attempt to draw one of three judges.

[175]See for example, M. Ballard, "Biggest Little Court in Texas: Plaintiffs Flock to Texarkana with Billion-Dollar Suits" Nat'l L.J., (30 Aug. 1999) A1, A10, noting the filing of numerous large cases in the Texarkana, Texas, federal court to get Judge David Folsom and referring to the technique as "pinpoint forum shopping."

filers in advance what judge will be assigned.[176] In a system that rotates the assignment of judges in a predictable order, the strategist has merely to observe which judge was assigned to the previous case or cases to know which judge will be assigned to the next case filed.[177] In a system that assigns cases randomly, the strategist typically looks for situations in which the judge it seeks to avoid is removed from the draw temporarily because of vacation, illness, imbalance in already assigned cases, or some other reason. Often, the chief judge of the court has the authority to bypass the random assignment system, opening the way for political corruption.[178] Strategists may file several identical cases, and then dismiss all but the one assigned to the desired judge.[179] In more sophisticated versions of the same strategy, the strategist files only a single case in the court, observes the assignment, and then decides whether to go forward or dismiss. If the strategist chooses dismissal, the strategist may later file in the same court or file in a different court. Other variations are possible.[180]

Strategists can also select courts – and thereby select more favourable panels of judges – by changing the nature of the relief they request. For example, wealthier taxpayers can avoid the notoriously pro-government judges of the tax court[181] by paying the tax and then suing for a refund in the United States district court. In Texaco–Pennzoil, Pennzoil tested the waters in Delaware by filing for injunctive relief, and then changed judges by dismissing that action and filing for money damages in Texas, before having New York judges imposed on them by Texaco's filings in New York federal and bankruptcy courts.[182]

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[176]See for example, G. Bermant et al., *Chapter 11 Venue Choice By Large Public Companies: Report to the Judicial Conference Committee on the Administration of the Bankruptcy System* (Federal Judicial Centre, 1997) 40–41, reporting the Delaware Bankruptcy Court's practice of advising prospective filers of the name of the judge who would be assigned to the case when filed.

[177]See for example, Weyrauch, *The Personality of Lawyers* (n 99) 225, n.17, "The attorneys hang around in the clerk's office until the proper letter is about to come up. As soon as this happens, they file their complaints."

[178]See for example, P. Yost, "Custom Broken in Cases Tied to President; Judge Picks Clinton Appointees to Preside" Boston Globe, (1 Aug. 1999) A13, revealing that the chief judge of the United States District Court for the District of Columbia bypassed the random assignment system to steer cases against friends of President Clinton to judges appointed by President Clinton.

[179]This form of shopping is considered unethical, even in the absence of any rule violation. See Samborn (n 175).

[180]For example, if a similar case anywhere in the United States has been assigned to a sympathetic judge, later filers can seek assignment to the same judge on the ground that their case is related to that one. See for example, B. Van Voris, "N.Y.'s Judge-shopping Channel" Nat'l L.J., (26 July 1999) A4, asserting that tobacco and gun plaintiffs are flocking to the United States District Court for the Eastern District of New York to seek related-to assignments to Judge Jack B. Weinstein.

[181]See D.A. Geier, "The Tax Court, Article III, and the Proposal by the Federal Courts Study Committee: A Study in Applied Constitutional Theory" (1991) 76 Cornell L. Rev. 998, showing, in an empirical study, that the government won 70.5% of district court tax cases and 90.4% of tax court cases in the same period.

[182]See *Pennzoil Co. v. Texaco Inc*., (1986) 481 U.S. 24 (Marshall, J., concurring), objecting to "the odor of impermissible forum shopping which pervades this case."

4.3.3.6 Settlement Strategies

The conventional view considers the settlement of cases a means of reaching approximately the same result litigation would reach, but at less expense. The concept is crystallised in Professors Mnookin and Kornhauser's memorable phrase "bargaining in the shadow of the law."[183]

Settlement can generate outcomes that lie entirely outside the range of possible outcomes from litigation. The operative leverages may result from the court's restrictions on continuing the litigation[184] or from the consequences of continuing aside from the ultimate decision.[185] For example, the litigant who can credibly threaten to embarrass the opposing party in the course of the litigation – perhaps by discovering facts that then become part of the public record – may be able to settle for more money than the litigant could win in court.[186] Similarly, the litigant may threaten an opponent with disclosure of business strategies or as-yet unpublicised vulnerabilities. An adverse result in litigation may have consequences that extend far beyond the specific matter in issue. Loss of a civil suit may lead to a criminal indictment.

The filing of a civil action may bring the plaintiff's or the defendant's conduct to the attention of law enforcement agencies.[187] One plaintiff's success in an obscure lawsuit may cause an avalanche of such suits by others. Settlement of the initial case prior to filing may have enhanced value because it could prevent such occurrences.

Commentators generally consider the settlement process harmless because they assume that parties are free to refuse a settlement that gives them less than they think they would win at trial.[188] This assumption is incorrect. Some judges attempt to "encourage" settlement of their cases through implicit threats of retaliation against recalcitrant parties, and thus make it virtually impossible for those parties

[183]R.H. Mnookin, and L. Kornhauser, "Bargaining in the Shadow of the Law: The Case of Divorce" (1979) 88 Yale L.J. 997, focusing on the role of law in divorce proceedings outside of the courtroom.

[184]See for example, E.D. Elliott, "Managerial Judging and the Evolution of Procedure" (1986) 53 U. Chi. L. Rev. 312, "One can in fact define managerial judging as the selective imposition by judges of costs on lawyers for the purpose of rationing the use of procedures available under the Federal Rules of Civil Procedure."

[185]See for example, K. Donovan, "Class Action War Heats Up" Nat'l L.J., (22 Dec. 1997) A1, asserting that companies often felt compelled to settle securities class action strike suits to avoid embarrassment.

[186]See ibid.

[187]See Harr (n 9) 491–492, describing how bitter, unsuccessful civil litigation over several years generated a record of environmental abuses that then made action by the EPA feasible.

[188]See for example, J. Cooper Alexander, "Do the Merits Matter? A Study of Settlements in Securities Class Actions" (1991) 43 Stan. L. Rev. 502.

to continue to litigate.[189] Though the written law may give the parties the right to refuse to discuss settlement, the party who actually refuses may suffer retaliation from the court.[190] Once the party is forced into negotiations by this threat, the party will encounter other norms, such as those requiring the party to divulge aspects of its case that would otherwise be confidential.

4.4 Implications

The theory of legal strategy we present here is capable of explaining several phenomena for which current explanations are inadequate or nonexistent.

4.4.1 The Effect of Superior Lawyering on Legal Outcomes

By the conventional view – made manifest both in bar examinations and judicial opinions – law is an extensive set of instructions to courts on how to decide cases.[191] Those instructions are necessarily incomplete in some respects and ambiguous in others. But the instructions are sufficient to render most cases "easy."[192] The judge's task in the remaining cases is to select the best result by resolving the ambiguity in light of social conditions and other factors. Were this traditional view correct, lawyers could, in most cases, look up the law before litigation and predict those cases' outcomes. Only rarely could the quality of lawyering change those outcomes.

Observations of the legal system in operation suggest that the quality of lawyering is highly correlated with success. The theory we have presented explains why. Legal outcomes are the products of complex human interactions in which the

[189]See for example, I.R. Kaufman, "Must Every Appeal Run the Gamut? – The Civil Appeals Management Plan" (1986) 95 Yale L.J. 755, noting that "settlements are neither dictated nor even necessarily driven by statutes and stare decisis"; See also T.D. Peterson, "Restoring Structural Checks on Judicial Power in the Era of Managerial Judging" (1995) 29 U.C. Davis L. Rev. 78, "The combination of managerial and substantive decision-making powers provides district judges with powerful leverage during the pretrial phase. Judges can use their power over substantive decision-making to coerce settlements and intimidate counsel into abandoning litigation theories or defenses."

[190]See D. Hurst Floyd, "Can the Judge Do That? The Need for a Clearer Judicial Role in Settlement" (1994) 26 Ariz. St. L.J. 49, "Additionally, because of a 'judicial zeal for settlement,' the increased opportunity for abuse may lead to judges punishing parties and lawyers who fail to cooperate in settlement."

[191]See for example, Lasswell and McDougal (n 7) 316–317, describing the traditional view as the "positivist frame."

[192]See Schauer (n 3) 413, "Following the law is a legal event, and the vast majority of these legal events are easy cases."

lawyer can draw not just on written law, but on social norms and prejudices, the law in action, the law in lawyers' heads, informal rules of factual inference, apparent system imperatives, community expectations regarding legal outcomes, and virtually anything else that might persuade the decision-maker.[193]

The skilled strategist knows that one can no more predict the outcome of a case from the facts and the law than one can predict the outcome of a game of chess from the positions of the pieces and the rules of the game. In either case, one needs to know who is playing.

4.4.2 The Strategic Transformation of Law

In the conventional view, the common law evolves according to the policy choices or "insight" of judges.[194] The alternative view – that litigants drive changes in the law – has been argued principally by Professors Galanter and Macaulay in the law-and-society literature[195] and principally by Professors Rubin and Bailey in the law-and-economics literature.[196] In Galanter and Macaulay's theories, the mechanisms of change are essentially case selection.[197] Although Rubin and Bailey have compiled impressive empirical evidence in support of their position,[198] they have not specified mechanisms by which litigants can substitute their own views for the views of judges.[199]

Our theory of legal strategy suggests an additional, and we think, more powerful, mechanism by which litigants can change the law. The mechanism has essentially

[193]See above Parts 4.2.1–4.2.2.

[194]See for example, R.A. Posner, *The Economic Analysis of Law* (1998) 275, assuming that judges control the evolution of the law.

[195]See above Part 4.2.1.

[196]See P.H. Rubin, and M.J. Bailey, "The Role of Lawyers in Changing the Law" (1994) 23 J. Legal Stud. 807 [Rubin and Bailey], proposing that the law is driven by the preferences of attorneys, not judges or litigants; See also P.H. Rubin, "Why is the Common Law Efficient?" (1977) 6 J. Legal Stud. 51, arguing that parties with a continuing interest in the establishment of efficient rules will invest resources to overturn inefficient results; See also R. Cooter, and L. Kornhauser, "Can Litigation Improve the Law Without the Help of Judges?" (1980) 9 J. Legal Stud. 140, "Litigants try to win their cases, not increase the law's efficiency, but the former may result in the latter." If litigation can improve the law, it must be able to change it.

[197]See above Part 4.2.1.

[198]See Rubin and Bailey (n 197) 817–821, linking the rejection of the privity doctrine to the rate of increase in the number of lawyers and noting efforts to link plaintiffs' law reform efforts through litigation groups.

[199]Professors Rubin and Bailey principally show that plaintiffs' lawyers are organized and motivated toward law reform favourable to their interests. They assert that those efforts result in favourable precedents. See ibid 808, "This is our basic hypothesis: The shape of modern product liability law is due to the interests of tort lawyers." But they make only vague references to means by which those motivations and efforts could generate precedents in spite of the contrary views of judges.

three stages. In the first, the litigant succeeds in bringing about a result that is contrary to expectations and conventional understanding of the written law.

In the second stage, others similarly situated copy the successful strategy. This copying is problematic. Successful legal strategy is not always recognisable as such; indeed, it is generally more effective when it goes unnoticed. But the moves that execute the strategy are usually disclosed in public hearings or on public records. Careful observers can piece them together. Even strategies never publicly disclosed or admitted are nearly always in some manner revealed to sufficiently observant opponents.

At this second stage, the decision-makers or other defenders of the status quo may attempt to neutralise the strategy. If they succeed, the strategy dies. They may fail, however, for a variety of reasons. The legal system relies on certain basic principles that are widely known and virtually impossible to change.[200] Those principles cannot be abandoned simply to deny the strategist's victory. Practical difficulties in making a necessary distinction may prevent the system from making an exception directed against the strategist.

Consider the example of a strategist who creates a judgment-proof business to engage in hazardous activity. To avoid exposing assets to the liability likely to be generated, the strategist rents both plant and equipment at arms length, sells its products only for cash, and distributes earnings to shareholders frequently. In an action by an injured plaintiff, a court might like to defeat the strategy by subjecting the plant and equipment to later judgments against the strategist. The court cannot, however, hold leased plant and equipment generally subject to the claims of tort creditors, because such a basic change in principles would disrupt the plant and equipment leasing industries. Nor can the court make an exception applicable only to strategists who deliberately judgment-proof their businesses. All uses of limited liability are deliberate, and every case in which the exception could be at issue is one in which the debtor ultimately had insufficient assets to pay the tort creditors. The court must allow the strategist to win, because if it does not, the court finds itself on a slippery slope that leads to massive social change.[201] The ultimate problem is the inability of the courts to make certain kinds of decisions with sufficient reliability. Unreliable rules or standards generate uncertainty that ultimately creates anxiety and interferes with planning. The legal system must draw lines where it can, which is not always where it thinks best. If the decision-maker

[200]See LoPucki, "The Death of Liability" (n 138) 8–13, describing the nine basic principles on which the liability system is constructed and which serve as the foundation for judgment-proof structures. These principles are not law, but deeper understandings as to the operation of society: that a person can own property is an example.

[201]See ibid 8, noting that the court will tolerate considerable amounts of unintended strategic activity because of the trauma involved in making basic changes. Working from an economic perspective, Professor Basu offers an alternative explanation of the court's inability to effectuate the written rule: "If a certain outcome is not an equilibrium of the economy, then it cannot be implemented through any law." Basu (n 20) 22.

cannot defeat the strategy at this second stage, the strategy changes the pattern of case outcomes.

At the third stage, the legal system recognises the triumph of the strategy by changing the written law to make it consistent with the case outcomes.[202] The system does so to eliminate the expense and embarrassment to the system of the strategic activity and the disparity in outcomes between strategists and non-strategists.

Additional examples of strategic transformation of law abound. During the late 1980s, aggressive debtors' lawyers changed the terms on which consumer debtors could adjust their debts under Chapter 13 of the *Bankruptcy Code*. Prior to the change, the conventional wisdom held debtors to a choice between the relief available under Chapter 7 (discharge of all debt, without the necessity to make payments to unsecured creditors) and the relief available under Chapter 13 (the ability to save the debtor's home from foreclosure, but only on the condition of paying all of the debtor's disposable income to unsecured creditors for a period of 3 years). Almost a decade after adoption of the legislative scheme, strategists invented a method for circumventing this choice that became known as a "Chapter 20" – a Chapter 7 case promptly followed by a second filing under Chapter 13.[203] By discharging his or her debts in Chapter 7 before filing the Chapter 13 case, the debtor assured that the "price" of Chapter 13 relief – payments to unsecured creditors – would be zero. Apparently unwilling to read into the statute words that were not there, the Supreme Court permitted a Chapter 20 case to stand, thereby putting its imprimatur on the change the strategists had effected.[204]

Finally, attorney Lincoln Brooks has developed a strategy that gives business debtors what is generally viewed as the most important advantage of a bankruptcy filing – the ability to stay and bind dissenting creditors – without having to file bankruptcy.[205] Prior to Brooks's strategy, the conventional wisdom held that "dissenting creditors cannot be bound in a workout, but they can be bound in Chapter 11."[206] Brooks's strategy is to grant a security interest in all of the debtors'

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[202]In the example of judgment-proofing presented here, the short-term result of acquiescence is that judgment-proofing succeeds; but the long-term result is an even more massive social change: the liability system fails. See LoPucki, "The Death of Liability" (n 138) 4, arguing that the ability to enforce a money judgment is essential to the system of liability, and that liability is essential to enforce American law. Judges occasionally acknowledge their lack of omnipotence over legal outcomes. See for example, *Hoffman v. Jones*, (1973) 280 So. 2d 437 (Fla.), giving as one reason for abolishing the rule of contributory negligence in Florida that juries may have been handing down compromise verdicts in violation of their duty to apply the rule.

[203]For a more complete description of the problem and the strategists' solution, See LoPucki, "Legal Culture, Legal Strategy" (n 28) 1533–1537.

[204]See *Johnson v. Home State Bank*, (1991) 501 U.S. 80, holding that a mortgage lien can be rescheduled under Chapter 13 even after the personal obligation secured by the mortgaged property has been discharged under Chapter 7.

[205]See LoPucki, "Legal Culture, Legal Strategy" (n 28) 1539–1541.

[206]M.S. Scarberry et al., *Business Reorganization in Bankruptcy: Cases and Materials*, (1996) 14.

assets to the Credit Managers' Association as trustee for all of the unsecured creditors. If a dissenting creditor attempts to levy, Brooks opposes the levy on the novel ground that it violates the newly minted secured creditors' right to priority. Though the case is weak on the written law, it is normatively strong and appealing from a systems standpoint. Brooks can argue that a few dissenting creditors should not be able to overturn the efforts of the majority to negotiate a solution to the company's financial problems. That appeal, combined with favourable economics of litigation, has enabled Brooks to win about 50 consecutive cases. Other lawyers have adopted similar techniques, thereby changing the delivered law.[207]

In each of these instances, the decision to make a change in how things were done was not made by a judge or a legislature, but by a strategist working on behalf of a party. Perhaps sufficiently determined judges or legislatures could have reversed the outcomes, if not in the cases where the strategies were first employed, at least in later cases. But even that is not clear. Legal strategy exploits vulnerabilities of the existing system. Comprehensive identification of these vulnerabilities is beyond the scope of this Article. Almost certainly among them, however, are (1) the inability of the system reliably to make desired distinctions, (2) the deliberate retention of "flexibility" in the legal system on the theory that it is necessary to accommodate change, (3) the lack of any social consensus as to the appropriate fora for the resolution of legal disputes, and (4) the diffusion of decision-making power among tens of thousands of judges in the United States alone. Vulnerabilities such as these give rise to the indeterminacies that legal strategists exploit.

4.4.3 Explaining Local Legal Cultures

Written law purports to be universal within geographical boundaries.[208] Because the same law applies throughout each jurisdiction, the conventional view suggests that legal outcomes should be uniform throughout each as well. Empirical research, however, has repeatedly discovered large variations in legal outcomes from place to place within jurisdictions, a phenomenon referred to as "local legal culture."[209] The mystery is why and how these systematic variations in legal outcome occur from one part of a jurisdiction to another when the law that supposedly generates them is the same.

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[207]For a more complete description of the problem and the strategists' solution, see LoPucki, "Legal Culture, Legal Strategy" (n 28) 1537–1541.

[208]Federal law purports to govern all transactions or occurrences within the United States and each state's law purports to govern transactions or occurrences throughout the respective state.

[209]See for example, T.W. Church, Jr., "Civil Case Delay in State Trial Courts" (1978) 4 Just. Sys. J. 181, referring to "a stable set of expectations, practices and informal rules of behavior which, for want of a better term, we have called 'local legal culture'"; See also T.W. Church, Jr., "Examining Local Legal Culture" (1985) Am. B. Found. Res. J. 451, referring to "the practitioner norms governing case handling and participant behavior in a criminal court."

The answers lie in the fact that several of the factors we have identified – social norms, the law in lawyers' heads, and expectations regarding outcomes – are not uniform within the neat boundaries of legal jurisdiction. They are forged by frequent interactions among members of groups. The locations of these groups are rarely co-extensive with the city, state, or national boundaries that define the reach of legal doctrine. Because social norms, the law in lawyers' heads, and expectations regarding outcomes are oral traditions, they may have little credibility to outsiders and little effect outside the group. The law in lawyers' heads may be different from city to city, or city to rural area, yet the same throughout national or international groups whose members interact frequently. Social norms exist within virtually every group of people who interact repeatedly, from the citizens of a nation to the members of a family.[210] They differ by religion, race, interests, geographical location, occupation, institution, and any other factor that brings groups together.

Such differences explain, at least in part, the processes by which local legal cultures arise, change, and disappear. The cultures are constantly in flux because the underlying factors that give rise to them are in flux. Through legal strategy, changes in social norms and expectations are translated into changes in legal outcomes, even while the written law remains constant. These changes in outcomes vary from place to place within a jurisdiction and change abruptly over time for the simple reason that the factors producing them, including legal strategies, change. If local legal cultures were merely the products of general cultural differences from place to place – the general practices, perceptions, and expectations of the people who live in a community – they could not appear and disappear nearly as quickly as they do.[211]

4.4.4 Why the "Haves" Come Out Ahead

The theories we present here extend Professor Galanter's theory as to why the "haves" come out ahead, by explaining new means by which spending more

[210]See for example, R.M. Cover, "The Supreme Court, 1982 Term-Foreword: Nomos and Narrative" (1983) 97 Harv. L. Rev. 30–33, describing social norms in various religious sects, company towns, and other non-sectarian settings; See also Weyrauch and Bell (n 14) 395; See also W.O. Weyrauch, "The 'Basic Law' or 'Constitution' of a Small Group'" (1971) 27 J. Soc. Issues 56–58, depicting the evolution of law when a group of Berkeley students were experimentally locked in a penthouse for three months.

[211]For example, when Chief District Judge Joseph J. Farnan, Jr. in 1997 took the unprecedented step of withdrawing the automatic reference of Delaware bankruptcy cases to the bankruptcy court and personally taking over the assignment of Chapter 11 cases filed in Delaware, the proportion of large Chapter 11 cases filed in Delaware instantly fell from 86% to almost 0%. See Eisenberg and LoPucki, "Shopping for Judges" (n 155) 986, reporting that only a single large, publicly held company filed for bankruptcy in the United States during the five months following Judge Farnan's order. Conventional legal theory would have predicted no change in filing rates because the newly assigned judges would be bound to follow the same law and procedures as the old.

resources[212] on litigation can produce more favourable outcomes for the spenders. If law operated in accord with conventional legal theory, resources would affect results only in the small minority of cases in which determinative facts remained undiscovered or the result specified by law was unclear. Yet, resources consistently produce good or acceptable results in what had seemed to be the most hopeless of cases.

Resources matter because they unleash strategy, and strategy is capable of altering legal outcomes across a wide range of possibilities. Adverse legal doctrine defeats only those who believe it can. For non-believers, the strategic application of resources can construct outcomes to order, within cultural limits. The more resources the party can spend, the better the outcomes the party is likely to get.

That does not mean that the party with greater resources will prevail – or even have an advantage – in every case. The resources that a party can profitably spend on a case are limited by the value of the case to that party. It follows that if a case involves only money – as many commercial disputes do – neither party should be willing to spend more than the amount in issue. Of course, if one of the parties is not sufficiently liquid, that party may not be able to invest optimally in the case. In addition, a given level of expenditure by opposing sides in a given case may do more for one side than the other, as where one side is a frequent litigator and can reap economies of scale.

The oblique allusion to matters that must remain unarticulated – is a principal skill of lawyer-strategists. Some lawyers will be better at it than others. That may occur because they have superior linguistic skills generally, or a better understanding of what can be left unsaid with the particular decision-maker. This difference in skill level inures to the benefit of those who can afford the best advocates. Although this will generally be the wealthier side, because of the contingency fee system, it is far from invariably so.

4.5 Evaluation and Conclusions

In the conventional model of the legal process, the lawyers present the facts of a case and the governing law to the judge. The judge applies the law to the facts to reach a decision. If the decision is wrong, the losing party can appeal to a higher court that will set it right. Settlements can, and usually do, occur along the way, but these settlements are merely estimates or approximations of the results the courts would otherwise reach. No room exists within that model for legal strategy.

[212]We use the term "resources" rather than "money" in recognition of the fact that lawyers may devote their time to particular cases for ideological reasons – pro bono work – and organizations may sponsor litigation for ideological reasons, such as a foundation sponsoring litigation to protect the environment. In either case, the effect is the fundamentally the same as an expenditure of the parties' own money.

The alternative model we have presented is a more open-ended one. When the stakes are sufficiently large, lawyers assume the role of strategists. They compete in the selection of decision-makers from an unlimited array of judges, arbitrators, private parties in settlement, or other persons. They employ a wide variety of strategies to reach or prevent adjudication. In the small minority of cases in which adjudication occurs, the strategists argue from a similarly wide variety of materials, which include social norms, law in action, law in lawyers' heads, informal rules of factual inference, system imperatives, community expectations, public policy, and written law. Because adjudicated outcomes depend so much on the predispositions of the adjudicators and the strategies employed in presentations, those outcomes differ widely from judge to judge, case to case, and place to place. Appeals are rare, and reversals even rarer. Strategy, not law, is the principal determinant of outcomes.

Once the dominant role of legal strategy is accepted, some undoubtedly will defend it on the ground that the vulnerability of the system to strategy gives the system an added measure of stability. That is, the system bends to accommodate power. We argue, to the contrary, that legal strategy renders legal outcomes unpredictable, making the system less stable. To the extent that strategies determine the outcomes of cases, the merits of cases as traditionally perceived do not. The injustice causes disrespect for the legal system, which ultimately undermines its legitimacy.

Because legal strategies are attempts to manipulate the outcomes of cases irrespective of their supposed merits under written law, strategies are widely viewed as unethical. Lawyers are reluctant to publicise the strategies they pursue partly for that reason. But an even more important reason is that most lawyers understand that strategies work best when unnoticed. Articulation can, and usually does, render them ineffective. These factors combine to drive legal strategy largely underground.

Some of the legal scholars who share our view of the ubiquity and importance of legal strategy view the problem of legal strategy as insoluble. Strategy, they say, permeates not only law, but life.[213] No matter what system is in place, strategists will attack it and transform it into something other than what was intended.[214]

Though we generally agree with this view, we think it ignores a key aspect of law-related systems:[215] they differ in the degree of their vulnerability to strategy. Better systems generate less strategic activity. That strategic activity is more likely

[213]See for example, conversation between L.M. LoPucki, Security Pacific Bank Professor of Law, UCLA Law School; T. Eisenberg, H.A. Mark Professor of Law, Cornell Law School; and J.A. Henderson, Jr., F.B. Ingersoll Professor of Law, Cornell Law School, (25 Sept. 1998).

[214]See Farber (n 27) 606, "A certain amount of formalism is unavoidable. As a result, the kind of moral risk dramatised by the story of the red-hot knife may be difficult to eliminate from any legal system."

[215]A "law-related system" is a system composed of people and objects in which formal law plays a role. See LoPucki, "The Systems Approach to Law" (n 37) 488–497, explaining the concept of a law-related system.

to be of the kinds anticipated or even intended by the systems' designers. Strategies can still gain advantage in the better systems, but they can gain less. Accordingly, the first means we propose for reducing the impact of strategy on legal outcomes is to redesign the legal system to provide fewer incentives for system-unintended strategy.[216]

Articulation offers a second means for reducing the impact of strategy on legal outcomes. The articulation need not be by participants in the case. Legal scholars can do it as well. Articulation will not be easy. Because the strategist conceals the strategy, the articulation is necessarily speculative, and therefore dangerous to the articulator. Inevitably, some articulations will miss the mark. Moreover, articulation operates largely by embarrassing the strategists, and, if it comes from a third party, such as the press or an empirical researcher, may also embarrass the judges and opposing lawyers who have been the strategists' unwitting victims. Thus none of the participants are typically willing to divulge information regarding the nature, use, or effects of strategy.

Articulation alone cannot solve the problem of legal strategy. Although its application tends to neutralise the articulated strategy, the effect is uncertain and usually incomplete. The court that receives a case may be embarrassed by the articulation of a forum-shopping strategy but not always enough to send the case back. The neutralisation of one strategy still leaves others effective.

In the coming age of information, the task of articulating legal strategy may become easier. Computerisation of the legal process – in the courts, in lawyers' offices, and in the offices of business and governmental clients – is documenting the pattern of cases and outcomes. Though such data generally does not capture the motives of participants and therefore does not document the strategies themselves, it does capture the footprint of those strategies in the form of disparities in legal outcomes from place to place, race to race, judge to judge, and, perhaps soon, lawyer to lawyer.[217]

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[216]Not seeing this potential for improvement, most scholars condemn strategy as unethical, exhort lawyers to refrain from engaging in it, and attempt to ignore strategy in their theories of the operation of the legal system. We consider their condemnations and exhortations ineffective and their attempt to ignore strategy misguided.

[217]Scholars have done most of their computer-assisted analyses of the legal process to date in databases that contain only legal opinions. Because legal opinions are non-systematic, self-serving descriptions of the legal process by persons with vested interests, they are a relatively weak form of data. Nevertheless, studies of them have already revealed interesting patterns. See for example, M.G. Duncan, *Romantic Outlaws, Beloved Prisons: The Unconscious Meanings of Crime and Punishment* (New York University Press, 1996) 195–196, exposing a pattern of discourse by prosecutors and courts that describe criminal defendants with metaphors of filth; See also Farole (n 17), showing that state governments win disproportionately in state supreme courts; See also R.B. Thompson, "Piercing the Veil Within Corporate Groups: Corporate Shareholders as Mere Investors" (1999) 13 Conn. J. Int'l L. 385–388, showing that despite judicial rhetoric to the contrary, piercing the corporate veil within a corporate group on behalf of a tort plaintiff is extremely rare.

Data capable of documenting the effects of legal strategy on legal outcomes already exists. Those who have it – principally the courts – are not likely to surrender it easily in usable form. But as the data is inevitably released, the existence and importance of legal strategy in the generation of legal outcomes will become increasingly difficult to deny. When that occurs, scholars, judges, and other participants will be forced to acknowledge strategy's dominant role in the legal process.

Chapter 5
Alternative Conceptions of Legal Strategy and Strategic Legal Interpretation

Bernardo Bolaños-Guerra, Guillaume Dupont and Emmanuel Picavet

Abstract In the formalist view of legal process as inspired by deontic logic, the law consists principally of rules in which the outcomes of cases are already implicit. In this view, the written law is the most important factor to legal outcomes. In the anti-formalist versions of legal positivism, courts are able to exercise judgment and discretion; they are not seriously constrained by written law, hence, judges are the most powerful factor. In both these views however, the role of lawyers and strategies is relatively unimportant. Contrary to this perspective is the work of LoPucki and Weyrauch which asserts that it is the strategic view of the legal process that captures its reality. LoPucki and Weyrauch claim that the evidence supports the view that lawyers are able to overcome both law and judicial discretion and determine legal outcomes. Under this perspective, the legal process itself is not just a matter of formal legal rules. Rather, the legal process is concerned with the strategic use of legal rules and principles. In this chapter, the authors challenge this perspective and identify that significant differences arise under their proposed alternative approach which takes relevant social processes into consideration. This chapter identifies some of the difficulties inherent in comparing the existing methodologies or approaches to legal strategy and defends an approach based on interpretations and strategic coordination of legal resources.

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5.1 Introduction

Conventional approaches to the legal process are inspired by legal logic[1] or deductive deontic logic.[2] In the formalist view of legal process as inspired by deontic logic, the law consists principally of a set of rules in which the outcomes of cases are already implicit. In this view, written law is the most important factor of legal outcomes. In the anti-formalist view of legal positivism,[3] courts are able to exercise judgment and discretion; they are not entirely constrained by written law, hence, judges are the most powerful agents. In both these approaches to the legal process, the role of lawyers appears relatively unimportant.

A "lawyer", for the purposes of this paper, can be understood as someone who is allowed to advocate specific interests by using his or her knowledge of legal systems, thanks to antecedent training in law. "Law" is broadly understood as a system of rules of conduct, as legal theories and/or as practical legal knowledge. We understand lawyers in a way that leaves out certain legal professions, in particular, judges. The main identifying features of lawyers are law-related education and the holding of a right to practice law-based activities.

Against conventional perspectives, LoPucki and Weyrauch[4] argue that the strategic view of the legal process provides a better grasp of its nature. They assert

[1]The term legal logic has different meanings. For example, "Perelman opposed nonformal logic to formal logic, saying that formal logic is about deductive and compelling arguments, while nonformal logic was about arguments which are, at best, convincing. As he also and rightly believed that in law most arguments are contestable and at best convincing, the implication of his approach is that formal logic only has a very limited relevance for legal reasoning. The consequence of this view is that the acceptability of legal argument is made dependent on associations, on analogies which as a matter of fact are convincing for an audience, on commonplaces, and so on. This allows empirical research of legal reasoning (which type of arguments are generally accepted, and so on), but it prevents rational analysis of legal reasoning". The rules of legal reasoning are legal logic. See A. Soeteman, "Do we need a legal logic?", A. Folgelklou, A. and T. Spaak eds., *Festskrift till Ake Frändberg* 221–234. (Iustus Förlag, 2003) [Soeteman]; See also C. Perelman, and L. Olbrechts-Tyteca, *Traité de l'argumentation: La nouvelle rhétorique*. (Presses Universitaires de France, 1958).

[2]"Deontic logic is often glossed as the logic of obligation, permission, and prohibition", noting that this definition is criticised for being too narrow. Stanford Encyclopedia of Philosophy, online: http://plato.stanford.edu/entries/logic-deontic/challenges.html. A well known deontic theorem is, that which is not forbidden is permitted therefore implying that everything is either prohibited or permitted which in turn suggests every act is subject to a norm. See Soeteman (n 1); See also G.H. von Wright, "Deontic Logic" in *Logical Studies* (Routledge and Kegan Paul, Londres, 1957) 58–74 (first publication in (1951) 60 Mind 1; See also G.H. von Wright, *Norm and Action. A Logical Enquiry* (Routledge & Kegan Paul, 1963).

[3]"Legal positivism is the thesis that the existence and content of law depends on social facts and not on its merits". Stanford Encyclopedia of Philosophy, online: http://plato.stanford.edu/entries/legal-positivism/. For further discussion of legal positivism see A.J. Sebok, *Legal Positivism in American Jurisprudence* (Cambridge University Press, 1998).

[4]L.M. LoPucki, and W.O. Weyrauch 2000, "A Theory of Legal Strategy" (2000) 49(6) Duke Law Journal 1405 [LoPucki and Weyrauch], an edited reprint in this text at Chap. 4.

that there is sufficient evidence to support the view that lawyers can overcome both law and judicial discretion to determine legal outcomes. The authors also argue that strategic approaches are almost completely absent from the realm of legal theory. It should be noted that a recent, notable exception is to be found in Backhaus' explicit theory of the role of lawyers in processes of constitutional interpretation.[5]

The law-and-economics literature has explored the application of game theory to the legal process.[6] However, LoPucki and Weyrauch believe that the strategy explored by law-and-economics scholars is fundamentally different from the strategy that is actually practiced by lawyers. *Homo economicus* either yields to the rule of law and seeks to maximise his or her advantage under it, or calculates the profits of violating the rule. In standard game theory, players cannot challenge the constitutive rules of the games they play. By contrast, lawyers often seek to legally defeat the strict application of legal rules.[7] The contrast is based on the fact that most game-theoretic or economic approaches to rule-based interaction presuppose an institutional structure, which is neither questioned by the agents nor scrutinised as the main object of study by the social scientist.

Economists usually start from a given structure of property rights and do not specialise in the analysis of the dynamics of the relevant normative structure. Of course, this is not universally true, because evolving property structures can be the main object of inquiry for some scientists. By and large however, it is true that most economists, political analysts and other social scientists usually take property-right structures as they are at a given time.

The practical relevance of this contrast seems to rely on a professional or cognitive divide. Lawyers play with rules, whereas the others (probably those who are less knowledgeable) are rule-takers, as it were – either they abide by the rules or they violate them – but, in any event, they are bound to take rules as they are. Whether the relevant divide should be based on the professions, or cognitively construed, remains to be elucidated.

A consequence of this divide is that it excludes ordinary people (those of us who are not law specialists) from a strategic perspective on law. Such a view is amenable to criticism, especially if we take due notice of the fact that ordinary social practice and interpretation-setting initiatives sometimes have a definite influence on the prevailing, gradually self-establishing forms of the social use of rules.[8] Abiding by the rules or violating them is only just one perspective on rule-based social action, but other dimensions are well worth being considered. In particular, the

[5]J. Backhaus, "Economic Principles of Constitutions. An Economic Analysis of Constitutional Law" (2001) The Independent Institute (USA), Working paper Series, No. 40 [Backhaus].

[6]D.G. Baird, R.H. Gertner, and R.C. Picker, *Game Theory and the Law* (Harvard University Press, 2002).

[7]See for example, LoPucki and Weyrauch (n 4) 1409–1410.

[8]S.J. Bailyn, "Who Makes the Rules? Using Wittgenstein in Social Theory" (2002) 32(3) Journal for the Theory of Social Behaviour 311–329; See also J-D. Reynaud, *Le conflit, la négociation et la règle* (Octarès Éditions, 1999); See also B. Reynaud, *Operating Rules in Organizations* (Palgrave Macmillan, 2003) [Reynaud]; See also E. Serverin, *Sociologie du droit* (La Découverte, 2000).

interpretative dimension turns out to be quite important if we are to understand how social agents establish cooperation among themselves, with the help of commonly recognised, gradually interpreted legal or political rules.[9]

5.2 Assessing the LoPucki–Weyrauch Theory of Legal Strategy

5.2.1 The LoPucki–Weyrauch Theory: An Overview

Theories of legal strategy are crucial in order to be able to explain what lawyers and other legal actors actually do when they practice law. In contrast with formalist approaches, these theories claim that the legal process itself is not just a matter of legal rules; it has to do with the strategic use of legal rules and principles. Strategic theorists set their sights beyond formal, merely legal, authority relationships. Strategic theorists recognise that written law and legal doctrine are not the same thing as real power, understood as the capacity of agents and groups to achieve desired results in the real world (to be distinguished from formal power, which we suggest can be identified with warranted expectations from legal knowledge and expertise). Strategic approaches acknowledge the determinant influence of legal strategies; the selective choice of legal alternatives can determine simultaneously the output of legal process and shifts in the underlying balance of effective power.

LoPucki and Weyrauch provide a compelling example of a legal strategy theory, even though it is not the only or first legal strategy theory asserted.[10] LoPucki and Weyrauch do not only give a description of some of the distinctive traits of legal strategic interactions, they also provide a model of typical attitudes in the interactions which are structured by legal strategic issues. However, the LoPucki Weyrauch theory does not concern itself with the challenge of explaining the methods of rule-learning and interpretation-setting by legal actors. It also does not generate any insight into the way power encounters or is assigned its actual limits in the real world. Dynamic compromise-building through legal interpretations should be considered in this respect. It plays an important role in the dynamics of power and therefore also plays an important role in the process of making rules effective one way or another.

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[9]R.L. Calvert, and J. Johnson, "Interpretation and Coordination in Constitutional Politics", E. Hauser, and J. Wasilewski eds., *Lessons in Democracy* (Jagiellonian University Press and University of Rochester Press, 1999), a version of article online: http://www.wallis.rochester.edu/WallisPapers/wallis_15.pdf [Calvert and Johnson]; See also P. Moor, *Pour une théorie micro-politique du droit* (Presses Universitaires de France, 2005).

[10]For example, after the Second World War, the American "legal process school" challenged both realism and formalism by describing legal systems as structures of decision-making processes. For further discussion see H.M. Hart Jr., and A.M. Sacks, *Hart and Sacks' The Legal Process: Basic Problems in the Making and Application of Law*, W.N. Eskridge, Jr., and P.P. Frickey eds. (West Publishing Company, 2001).

All in all, legal strategy appears to be one component of strategic thinking, arguing and decision-making on the part of legal actors. LoPucki and Weyrauch hold that written law only has direct effect through rulings in actual cases, and indirect effect through the expectation of rulings in "hypothetical cases". We suggest however that perhaps this is not the end of the story. There is no denying that written law influences the allocation of power and subsequently the actual enforcement of rules in social life. Legal rules and principles play an important role as focal points for lawyers and institutions, because legal strategies in institutional contexts have to refer to existing principles and norms. Even in a theory of legal strategy there is room for the common recognition of legal authority, precedents and public commitments or attitudes. Indeed, such recognition plays a structural part in the evolution of institutional cooperation and conflict. Such processes do impact the way rules are made effective, *via* the shifts in the real power of various institutional agents.

LoPucki and Weyrauch conclude that within the wide range of what is culturally acceptable in legal outcomes, legal strategies, rather than written law or legal doctrine, are the primary determinants of who decides cases, under what constraints, and with what consequences. We resist this conclusion, as it does not appear to be fully implied by those assumptions we find attractive in the LoPucki–Weyrauch theory. We hold that legal strategies, for all their importance, do not nullify the specific operation of legal norms and legal principles and their associated meanings. On the contrary, shared evolving meanings and meaning-based coordination devices help to understand the nature of the operating rules and, consequently, the effectiveness or failure of specific legal strategies.

Although its radical implications are deeply unconventional, the LoPucki–Weyrauch theory is based on a conventional realist approach of the nature of law. Most legal realists stand against legal formalism and claim that legal statutes and precedents do not determine the results of legal disputes. They are typically interested in externalist approaches to the law (sociological, anthropological, economic, etc.) and in promoting specialised studies of judicial behaviour.[11] Even if LoPucki and Weyrauch do not claim that legal decisions are always determined by the clash of social interests, they hold them to be the result of the legal skills of agents.

In contrast, we question the realism–formalism dichotomy, drawing attention to the complementarity of strategic and hermeneutic[12] issues in interactions which happen to be structured by norms or principles. In particular, we suggest that

[11]The general idea here is that social forces are given effect through the judge. See F.S. Cohen, "Transcendental Nonsense and the Functional Approach" (1935) 35 Columbia Law Review 832–847; For further general discussion on American legal realism, see W.W. Fisher, M.J. Horwitz, and T.A. Reed eds., *American Legal Realism* (Oxford University Press, 1993); On Scandinavian legal realism see J. Bjarup, "The Philosophy of Scandinavian Legal Realism" (2005) 18(1) Ratio Juris 1; For a comparison, see M. Martin, *Legal Realism: American and Scandinavian* (Peter Lang Publishing, 1997).

[12]*Hermeneutics* concerns itself with the study of interpretation theory.

current legal strategy theories need to be widened in order to allow for the distinctiveness of the legal process as a game played with hermeneutic strategies. In this approach, legal sentences become a very important factor in legal outcomes with meaning-based coordination among legal actors also entering the picture.

5.2.2 *Legal Processes: Between Games of Skill and Coordination*

According to the LoPucki–Weyrauch theory, there are large odds that some combination of decisions, issues, and problems will determine each legal outcome. The legal strategist manipulates those factors in a "game of skill", expanding and developing the array of decisions, issues, and problems in such a way as to confuse and ultimately win over the opponent. In opposition to this standard legal-realist theory, our approach relies on the important role of innovation in interpreting and applying rules, in an effort to reconcile evidence from empirical work[13] with relevant insights from benchmark theoretical models.[14]

For example, European treaties and Community rules are the expression of a normative system which effectively constrains legal strategies. This constitutional layer is used by institutional actors as a set of argumentative/normative, not only strategic, resources. Producing interpretations and justifications (or reasons) is the kind of behaviour imposed by the political system on the participants and choice of strategies. The interpretation of constitutional principles and legal rules thus becomes an important interface between legal formalism and legal strategy. Effective (or real) power in the implementation of rules partly results from strategy, and it can be said the other way round, that guesses about real power give shape to strategy. However, strategy itself is only to be understood if we take good care of the structure of formal power, no matter how indeterminate it might be at first sight. On the one hand, this theoretical attitude surely takes us farther away from individual mental processes, leaving it open to be criticised by some in the individualistic tradition. On the other hand, it can be credited with relying quite safely on objective social constraints and meanings in a way that is conducive to a better understanding of the challenges faced by institutional actors in institutional

[13]See A. Isla, "Le contrôle communautaire des aides d'Etat", S. Ngo-Maï, D. Torre, and E. Tosi eds., *Intégration européenne et institutions économiques* (De Boeck, 2002); See also P. Le Galès, "Est Maître Des Lieux Celui Qui Les Organise: When National and European Policy Domains Collide", A. Stone Sweet, W. Sandholtz, and N. Fligstein eds., *The Institutionalization of Europe* (Oxford University Press, 2001) 137–154; See also S. Lefèvre "Interpretative Communications and the Implementation of Community Law at National Level" (2004) 29(6) *European Law Review* 808; See also V. Louri, "'Undertaking' as a Jurisdictional Element for the Application of EC Competition Rules" (2002) 29(2) Legal Issues of Economic Integration 143.

[14]See J. Backhaus (n 5); See also R.A. Heiner, "The Origin of Predictable Behavior" (1983) 73(4) American Economic Review 560; See also Reynaud (n 8).

contexts (where collective acceptance of interpretations are perhaps more important for explanatory purposes than the corresponding mental events).

To summarise, according to our preferred approach, the game of law is a game of clever interpretations yielding contextually dependent legitimacy as well as the furtherance of institutional goals. On the contrary, the LoPucki–Weyrauch view of interpretation emphasises the subjective element. Against the conventional view, their strategic view holds that the "proper" interpretations of law are an "unverifiable process occurring in the minds of judges and jurors and hence beyond effective examination of criticism".[15]

LoPucki and Weyrauch concede that written law may have an indirect impact on judicial decisions, due to the fact that lawyers' strategies are the determinant factors. Lawyers have to plead, if only rhetorically, in accordance with legal norms and constitutional principles. Ultimately, legal strategy has the form of a suggested *interpretation* of given principles and rules: with this we agree. Furthermore they claim that judges and their interpretations are the ultimate factors in the process through which one among the conflicting opposite strategies of lawyers is to be declared successful.

The analysis in Picavet, Dupont, Dilhac and Bolaños-Guerra[16] (PDDB or PDDB Model) commits us to the following hypotheses:

(a) In legal processes, participants often have a common special interest in setting the bases for future coordination among institutional actors in their society. Legal strategy and legal interpretation are intermingled to a considerable degree, with legal interpretations playing the coordinating role in attenuation of the competitive and the antagonist role of legal strategies.
(b) Coordinating attempts on the part of particular legal actors are influenced by lawyers and have an influence on the interpretation of legal rules, constitutional principles, international treaties and legal doctrine, which are referred to by lawyers and other legal actors.
(c) Judges settle innovative cases in a way which may be influenced by successful strategies by lawyers, and, at the same time, they settle the conditions for future coordination among agents. Innovative cases become common references or *precedents* for successful coordination in the future. *Interpretations* become guidelines for future agreements; they are central mechanisms for building coordination over time, as emphasised in the model developed by Calvert and Johnson for the purpose of explaining, in a simultaneous way, the path of coordination in constitutional interaction and the evolving meaning attributed to a set of overarching principles.[17]

[15]LoPucki and Weyrauch (n 4) 1424.

[16]E. Picavet, M. Dilhac, G. Dupont, and B. Bolaños-Guerra, "Identité et nouveauté des situations politiques", *Le même et l'autre identité et différence* (2006) Proceedings of the 31st Congress of the Association of French-Language Philosophical Societies, Budapest [PDDB].

[17]Calvert and Johnson (n 9).

5.2.3 *Reconsidering the Texaco–Pennzoil Case: The Role of Legitimacy*

In order to "frame the conflict between the strategic and conventional views of the legal process",[18] LoPucki and Weyrauch consider their application to the struggle between Texaco and Pennzoil over Getty Oil.[19] The strategic account of the Texaco–Pennzoil case is as follows: Pennzoil negotiated an "agreement in principle" to purchase Getty Oil. That agreement was approved by Getty, but while the remaining terms of the written agreement were being negotiated and drafted, Texaco persuaded Getty to sell to Texaco rather than Pennzoil.[20] Even though the case has generally been acknowledged to have been weak on the merits, a Texas jury concluded that Texaco interfered with the agreement between Getty and Pennzoil, and that Pennzoil was damaged in the amount of $7.53 billion dollars, with an additional $3 billion in punitive damages.[21] The judgment did not really bankrupt Texaco, even if the latter pretended strategically it did. "The predominant and perhaps sole purpose of the bankruptcy appears to have been to create a delay that would enable Texaco to pursue its appeals".[22] Thanks to this strategy, Texaco settled with Pennzoil for a cash payment of only $3 billion. LoPucki and Weyrauch hold that the supposed bankruptcy and $3 billion payment were the consequences not of the application of law to the facts of the case (as the formalist view pretends), but of a confrontation of two legal strategies.

As we have said, the LoPucki–Weyrauch strategic view is associated with the opinion that interpretations of law can be equated with unverifiable processes occurring in the minds of judges and jurors and that judicial decisions reflect the best competitive strategy. However, that view fails to bring in some of the determinants of the outcome in Pennzoil vs. Texaco. LoPucki and Weyrauch say that "for reasons never made public, but *which may also have been of a strategic nature*, Pennzoil did not raise the bad faith filing issue in the bankruptcy case".[23] They also recognise that "the settlement was well below the expected value of the judgment in litigation under an economic analysis, *suggesting that other, not-yet-revealed factors* held down the amount".[24] This observation amounts either to a potential useful prediction (if such factors can be identified at a later stage) or to a mere label posted onto unknown mechanisms. We propose another approach because some potentially relevant identifiable mechanisms are already known.

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[18]LoPucki and Weyrauch (n 4) 1414.

[19]*Texaco Inc. v. Pennzoil Co.* 729 S.W.2d 768, 748–787 (Tex. App.) rev'd, 481 U.S. 1 (1987).

[20]LoPucki and Weyrauch (n 4) 1414 citing *Texaco Inc. v. Pennzoil Co.* 729 S.W.2d 784–787 [*Texaco*].

[21]Ibid 1414–1415 citing *Texaco* ibid 784.

[22]LoPucki and Weyrauch (n 4) 1422.

[23]Ibid.

[24]Ibid 1423.

A central mechanism emerging from Calvert and Johnson[25] and PDDB[26] is that legal actors are able to build inter-temporal policy coordination in such a way as to ensure future efficient coordination at the cost of sacrificing immediate institutional goals. During the legal process, in which communication, social and political pressures and legal action alternate, Pennzoil seemed to have sacrificed an important part of its immediate interest, publicly considered as illegitimate. Indeed, the settlement of the case was again "well below the expected value of the judgment in litigation under an economic analysis".[27] While the formalist conventional view claims that this legal outcome can be explained by the fact that Pennzoil had a weak case on the legal merits, on the contrary, LoPucki and Weyrauch pretend that this or any particular settlement is highly serendipitous. Between those extremes, the PDDB Model emphasises the role of legitimacy in the legal interpretation and implementation of substantive legal rules and principles.

Let us review some crucial details of the case.[28] Pennzoil was searching for a court which would be sympathetic to its goal. It tried three legal actions in Delaware, Tulsa and Houston respectively. It was the action in the Houston court that ultimately gave a $10.53 billion dollar verdict against Texaco.[29] The latter's failure to file an answer in Delaware court became known later as the "10 billion dollar boo boo".[30] Indeed, LoPucki and Weyrauch recognise that Pennzoil did not give Texaco notice of its intent to dismiss the Delaware action, deliberately ignoring a local custom. Had Pennzoil given notice, Texaco would have filed an answer. Had Texaco filed that answer, it is highly probable that it wouldn't have lost the case.[31] The legitimacy of ignoring a local custom for strategic purposes is, of course, problematic for the firm and its image in the corporate world as well as in the general public. Although LoPucki and Weyrauch correctly recognise the great importance of the strategic Pennzoil's decision not to give notice, they ignore the potential importance of legitimacy issues.

The Houston case was assigned to Judge Farris. Only two days after the assignment, Pennzoil's lead counsel in the case contributed with $10,000 to Farris' re-election campaign.[32] Texaco's action on the basis of the donation was unsuccessful.[33] The legitimacy of the Farris ruling could be doubted.

Neither the formalist perspective nor the LoPucki–Weyrauch model is sufficient to explain why, after the verdict, Texaco launched a media campaign seeking to

[25]Calvert and Johnson (n 9).

[26]PDDB (n 16).

[27]LoPucki and Weyrauch (n 4) 1423.

[28]See generally ibid 1415–1416.

[29]Ibid 1416.

[30]See ibid 1416 quoting S. Coll, *The Taking of Getty Oil: The Full Story of the Most Spectacular – and Catastrophic – Takeover of All Time* (Simon & Schuster, 1987) 386.

[31]LoPucki and Weyrauch (n 4) 1417.

[32]Ibid.

[33]Ibid.

convince the public opinion that Texaco had suffered an injustice. LoPucki and Weyrauch claim the obvious purpose of the campaign was "to affect the court's future rulings",[34] but from a merely strategic perspective, what is the point of appealing to the "true meaning of law", to abstract justice or objective morality? If there were only strategy and interests, truth-based or morality-related legal interpretations would have no specific role.

The legitimacy deficit of the Pennzoil strategy manifested when the Securities Exchange Commission (SEC) announced that it would file a brief in the Texaco appeal arguing that Pennzoil had broken SEC rules in its bid for Getty. LoPucki and Weyrauch recognise that Pennzoil could have insisted on receiving the "excessive" amount originally determined by the judge, but preferred an out-of-court agreement. According to Sun Tzu,[35] the perfect victory is when the opponent surrenders before fighting; similarly, we might say that the best legal victory is an attractive agreement which carries a reasonable interpretation of law. Maximalist legal strategies – those that involve the full use of formal prerogative – could be prejudicial in the long run, when they erode the legitimacy of the legal process. Admittedly, individual firms are not necessarily committed to such long-term legitimacy issues to a sufficient degree – so that the collective action problem is tamed – but reputation issues also matter in ordinary business including the connection to key relationships with business partners and the general public.

During the legal process, mutually accepted arguments concerning appropriate conditions of competition and efficient litigation are gradually discovered. These "agreements" assume the form of legal interpretations. Thus, legal strategies should perhaps not maximise immediate benefits beyond some limit, such limit as determined by cultural background and contemporary legal doctrine. The idea here is that because norms as coordinating devices offer resources for efficient interaction in the future, so too do mutually acceptable agreements which rely on precedent-making interpretative choices.

5.3 A Comparison of Theoretical Strategies

In our PDDB Model as described briefly above, we have put forward an analysis which seeks to explain the strategic uses of legal rules in order to explain what legal actors actually do when they behave strategically with respect to the law. Both the LoPucki–Weyrauch approach and our approach claim that the legal process itself is not just a matter of formal legal rules. Rather, the legal process has a lot to do with the strategic use of legal rules and principles. Both these analyses set their sights beyond formal, i.e. merely legal authority relationships in an effort to grasp the operation of rules in a realistic manner and recognise that written law and legal

[34]Ibid 1419.

[35]Chinese military strategist and author of *The Art of War* written approximately 2,500 years ago.

doctrine are not the same thing as real power.[36] Both approaches acknowledge the key role of legal strategies: in real social processes, the selective choice of legal alternatives is able to simultaneously determine the output of legal process and shifts in the underlying balance of effective power. However, our approach ascribes more emphasis to legitimacy as a condition for successful legal strategies and a guide for legal interpretations.

A possible advantage of the LoPucki–Weyrauch theory over the PDDB Model is its focus on lawyers as legal actors, which results in a more straightforward inclusion in the explanatory strategies associated with methodological individualism. In contrast to what is meant by LoPucki and Weyrauch to be a general theory of legal strategy, our approach aims at providing a description of some of the distinctive traits of institutional strategic interactions: a model of typical institutional attitudes in interaction and structured by strategic issues and underlying rules. Accordingly, the emphasis here (and in Backhaus[37]) is on the institutional interaction between groups of social agents. The PDDB Model is thus primarily concerned with the challenge in explaining the methods of rule-learning and interpretation-setting in a world of institutions. Further, the main scientific challenge is to arrive at a better understanding of the way institutional power encounters or acquires its effective limits in the real world. In this respect, the PDDB Model asserts that dynamic compromise-building through legal interpretations plays an important role in the evolution of power. The approach taken is largely inductive in character, as it starts from key observations of complex and heterogeneous institutional interactions and thus it is still short of a *general theory of legal strategy*. Legal strategy is arguably only one component of strategic thinking, opportunities for argument and actual decision-making on the part of institutional actors.

LoPucki and Weyrauch hold that written law only has direct effect through rulings in "actual cases", but indirect effect through rulings in "hypothetical cases" is important too. Under the PDDB Model, written law impacts the allocation of power and legal strategies have to refer to existing principles and norms in order to be successful. Hence, even in a theory of legal strategy, we claim, there is room for mutual recognition of legal authority, precedents and public commitments. Indeed, recognition of this sort plays a structural part in the evolution of institutional cooperation and conflict and thus, indirectly, plays a role in those processes which harbour institutional change and changes in the structure of real power.

LoPucki and Weyrauch claim that legal strategies are the primary determinants of legal outcomes. We hold that successful legal strategies are a combination of interpretations and strategic coordination, based upon legal norms and legal principles and their associated meanings. Shared evolving meanings and

[36]E. Picavet, and D. Razafimahatolotra, "Sur la formalisation de la pluralité des interprétations en matière normative" (2008), Working Paper Congrès de la Société de Philosophie des Sciences, Genève (session DELICOM: *l'étude scientifique du débat public,* 31 mars 2007), online: http://www.sps.ens.fr/publications/Picavet-Razafimahatolotra.pdf; See also P. Aghion, and J. Tirole, "Real and Formal Authority in Organisations" (1997) 105 *Journal of Political Economy* 1.

[37]Backhaus (n 5).

meaning-based coordination devices help to understand the effectiveness or failure of legal strategies.

5.4 Conclusion

We have argued that the theory of legal strategy in LoPucki and Weyrauch is faithful to legal realism. However, there is room for an alternative approach which draws better attention to the complex structure of real legal processes. The latter involves strategic games played using legal hermeneutics. Even though substantive legal norms and principles do not have a rigid, unique and permanent meaning, their content and application can raise legitimacy issues.

Social expectations determine the limits of acceptable legal interpretations. When the goal of legal strategy is to advance private interest, it is constrained by the public perception of the limits of acceptable legal interpretation or what we have called legal "legitimacy". Legal legitimacy may be regarded as a feature of some sort of equilibrium of legal interpretations. It requires every efficient legal strategist to possess information about social expectations. Legitimacy can be recognised by the legal interpreter through the legal values of well-informed people, i.e. through reference to a common set of beliefs about what is permissible and forbidden.

In our view, the mechanism which accounts for the existence of social limits to legal interpretations is the fact that legal outcomes also function as norms and principles; decisions become binding precedents. If legal strategy were to be understood as unbounded, anything would go – there would be no social meaning of law, nor any shared social expectations from which to form legal strategies.

Chapter 6
The Crucial Role of Legal Capability in the Realisation of Legal Strategies

Antoine Masson

Abstract In this chapter, the author examines firms' potential to launch legal strategies. To this end, the author first attempts to identify what creates the capability within a firm to transform a legal resource or legal opportunity into a competitive legal advantage. Second, the author looks at the circumstances under which a firm decides to invest in the enhancement of this legal capability. Third, the author discusses why a firm might decide to mobilize such a capability to initiate a legal strategy.

6.1 Introduction

The innovative use of legal resources[1] can make it possible for a company to obtain a comparative legal advantage, i.e. place itself in a legal situation more favorable than that of a competitor. Furthermore, it has been observed that the strategic opportunities generated from the use of legal resources are often only accessible to major economic players. However, if the effective realisation of existing strategies depends upon the availability of legal resources,[2] why then do differences exist between similar companies belonging to the same legal system who therefore have

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[1]In this article, a legal resource refers to either the mobilization of a legal opportunity or the use of a specific rule, which, under a certain circumstances, will increase firm performance. Contrary to a first situation where the exploitation of a sole legal opportunity might lead to economic advantage per se, it is only through the use a specific combination of legal resources that can confer a competitive legal advantage to a firm. Consequently, it may be more appropriate to speak of legal optimisation in this latter situation than legal strategies.

[2]For a general analysis of legal resources, see C. Roquilly, "From Legal Monitoring to Legal Core Competency: How to Integrate the Legal Dimension into Strategic Management" (2009), Chap. 2 of this text.

A. Masson and M.J. Shariff (eds.), *Legal Strategies*,
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at their disposal, the same legal opportunities? It appears that the ability to turn legal resources or pathologies into legal advantage requires a certain level of capability[3] within the company. Accordingly to the dominant managerial approach, it is the legal capability of each firm (i.e., the combination of know-how, knowledge and pro-active management of both internal and external legal information flow[4]) which gives it the possibility to deploy, in an efficient manner, its legal resources in order to achieve its business objectives and consequently to take advantage of its legal environment.

If the notion of legal capability can explain the pro-active attitude of certain firms in relation to their legal environment, this notion does not explain all the differences of situations existing between two firms within a specific legal environment. Indeed, the resource approach postulates that firms can mobilize any resource at their disposal, even if it is only firms with a certain legal capability that can do it in an effective manner. However, if the efficient deployment of legal resources is undeniably a question of capability, this reasoning omits to take into consideration the fact that certain resources require certain factual or legal conditions to be mobilized in a specific manner. For example, if any firm can use the court to defend its rights, not all firms can use a lawsuit to attract public attention or to threaten competitors.[5] Thus, in order to expand on earlier contributions in this area, we need to first identify the different elements that determine the legal capability of a company. Second, we need to consider why companies make the decision to invest in its legal capacity so that legal resources can be transformed into legal advantage. Third, we need to consider why companies then make the decision to use or launch a legal strategy.

6.2 The Main Elements of Legal Capability: A Typology

The ability to use regulatory frameworks strategically requires that lawyers summon the various legal resources at their disposal but also requires them to take into consideration, the nature of the regulatory framework as defined by public

[3]The notion of legal capability is used here to underline the idea that each firm has a different potential for implementing legal strategies as well as the idea that firms have the ability to invest in such potential in order to increase their aptitude or capacity to successfully initialise legal strategies.

[4]Constance Bagley uses the term of "legal astuteness" to highlight the importance of five elements related to a firm's legal performance, these are: (1) managers' perception of the importance of law; (2) managers' implication in the resolution of conflict and in the drafting of contract; (3) the ability for non-lawyers to solve legal issues; (4) the frequency and the intensity of the exchanges between lawyers and non-lawyers; and (5) the role of the legal department. See C.E. Bagley, "Winning Legally: the Value of Legal Astuteness" (2008) 33(3) Academy of Management Review 378.

[5]For this reason, the term "legal capital" which includes firms' legal capability, "tools" and legal prerequisites at the disposal of a firm to exploit its resources, should be preferred to explain the differences that exist between firms regarding the possibilities for using law as a weapon.

authorities. Accordingly, what follows is an attempt to identify the most significant elements of legal resources and then classify them according to the companies' degree of command over them.

6.2.1 Weak Command

Resources that are difficult to improve even though they may be within the legal capability of a company.

6.2.1.1 Existence of a Privileged Legal Position

Firstly, a privileged legal position of a company is often a result of the economic power of the company. For example, when the term of a supply of goods contract comes to an end, a buyer can try to renegotiate more advantageous conditions which the supplier may not be able to refuse if it is economically weaker because it has, for example, recently made important investments.

Secondly, the legislative desire to protect certain parties considered as weaker – frequently justified from a general point of view – has resulted in the granting of protections that can be used strategically. Without a doubt, the most obvious example here is the French insolvency law which imposes the selective continuation of ongoing contracts.[6] Indeed, in order that the survival of a company not be threatened, the law provides that contracts essential to its daily functioning cannot be terminated during an insolvency procedure.[7] This requires the company's contracting partners, who have not been paid for the period preceding the opening of the insolvency procedure, to continue to provide services if deemed necessary by the executive officer of the company, thus causing them to ignore their position in respect of their own suppliers. In this situation, the only real constraints on the company are the requirements to pay immediately and to make sure that funds will later be available to pay creditors. Additionally, payment delays, reduction on payment of interest or even partial reduction on the amount of its debts can be granted in order to save a company in such a situation. This protection arrangement allows the company to improve its cash-flow and benefit from mostly free financing and favorable payment delays while at the same time, requiring its rival companies, healthy and well-managed, to respect their own financial commitments, including the payment of interest.

Similarly, a buyer of the insolvent company will find itself in a more complicated regulatory situation than a buyer of a healthy company. Indeed, in order to prevent a buyer from making substantial profits by reselling assets bought on the cheap, French law requires that the buyer indicate what its resale plans are for

[6]F. Derrida, "La Notion de Contrat en Cours, à L'ouverture de la Procédure de Redressement Judiciaire" (1993) R.J.D.A. 399.

[7]Ibid.

the following two years. If this provision is included in a judgment confirming the acquisition of the insolvent company, it becomes compulsory on the buyer and thereby strongly limits its liberty as compared to its opponents who benefit from complete transactional freedom.[8]

6.2.1.2 Mobility of Company's Production Factors (Capital and Labor)

This criterion is fundamental in determining the forum shopping capacity of a company. Indeed, some business activities are by their very nature more difficult or even impossible to transfer. This will be the case, for example, when the activity is linked to customers who are not mobile and/or where the personal element is strong, as seen with the legal or medical profession, or in certain economic activities that require long term relationships with suppliers, for example, the automobile industry.

6.2.1.3 Activity of the Company

Economic activities provide varying degrees of legal opportunity. For example, regulated sectors, subject to higher levels of regulation, are often the origin of legal strategies that seek to benefit from the complexity of the laws applicable to that particular sector of activity. For example, if the objective of a regulated sector is the putting of an end to the historical situation of monopoly, it can often be observed that the result will be both the reduction of economic barriers of entry on the one hand and the creation of legal barriers on the other.

6.2.1.4 Economic Weight

Firstly, legal capital will vary depending on the economic weight of a company. For some companies, economic weight will dictate the amount of time they will be able to spend on legal strategies. Further, larger companies reap a direct profit from regulatory complexity because of the increased entry cost for opponents which in turn reduces the possibility for these rivals to have recourse to legal strategies. Thus, the constant evolution of law can prevent small businesses from applying certain strategies because of the difficulty for them to manage the flow of legal information.

Secondly, the size of a company can itself be a tool in creating a more favorable normative framework. This can be observed in the case of relocation blackmail, where a company threatens to leave a region or a country if it does not receive

[8]The overuse of criminal law which requires no legal expertise, as implementation and prosecution is handled by a public prosecutor, is also a typical example of this phenomenon.

normative advantages. Moreover, the size of the company can enable it to realise substantial volume savings in the resources mobilized to put a legal strategy in place. Indeed, some strategies are only interesting or worthwhile if implemented on a large scale, for example, judicial militancy which requires repeat players. Furthermore, size can affect the probability of a company to be punished for having applied certain types of strategies. For example, the nature of administrative and regulatory control is partly conditioned on the size and legal structure of the corporate entity, i.e. the form of company, group of companies, etc.

Indeed, the complexity of certain legal structures will be a deterrent for authorities because of the ensuing increase on control costs. Because these authorities are also restricted by certain performance requirements, they will be less inclined to control complex companies. In this respect, it would appear that medium-sized companies might offer the best in both economic and symbolic return. For example, in France, the legal and medical professions are less often controlled by tax authorities than contract workers, despite the fact that the opportunities for fraud in the former two professions are arguably higher.

Notwithstanding the foregoing, economic weight can also be a source of liability. Indeed, the size of a company can increase its regulatory constraints. For example, Belgium labor law creates an obligation on a company to establish an internal business council or "Conseil d'entreprise" once a certain threshold of worker numbers has been reached.[9] Similarly, competition law will exclude companies from its scope based on thresholds linked to sales or market share. That being said however, the development of regulatory constraints can also have a stimulating effect on legal capital because it encourages a company to invest in its legal resources so that it can maximise its relations with third-parties. On the other hand, economic weight might also encourage eccentric consumer litigation or legal blackmail which is intended to settle amiably but with a comfortable financial solution.[10]

Finally, the size of the company can prevent it from having recourse to certain types of strategies. For example, because of its need to create relations of proximity with users, a company that has already established a global presence will insist and support strategies aimed at framing the normative environment rather than those aimed at forum shopping for example, such a strategy being of little interest in these circumstances. As an example normative environment framing, at the same time that Microsoft was sued for anti-competitive practices it was also signing deals with several European governments to finance research centers. This activity could be perceived as a way of putting pressure on national governments in respect of its ongoing feud with European competition authorities.

[9]Under Belgian law, a Conseil d'entreprise must be created in a firm that has more than 100 workers. Its competences include the settlement of: annual holidays and the days of recovery for public holidays; management of social activities; and designation of external auditors. In addition, it collects information on the social, economic and financial data of the company.

[10]Some lawyers remunerate certain individuals to be the lead plaintiffs in class action proceedings.

6.2.1.5 Perception of Law

Stéphane Woog in his book, *Stratégies du Créancier*,[11] clearly insists on the necessity of taking into account, inter-subjectivity, i.e. the perception of others.[12] Accordingly, certain symbols or signs in the business world, such as mention in a Company Registry, a mailing address or the legal form of the company, can be seen to elicit certain biases that can influence the outcome of a given situation. Furthermore, shared perceptions of law can also provide some companies with the opportunity to apply pressure to others. For example, because of the aura surrounding Competition law, the threat of legal proceedings for an illicit collusion can make the re-negotiation of a contract easier.[13] In the same way, certain guidelines, like conduct guidelines, which are not enforceable per se, are perceived by others as allowing for the implementation of strategies.

6.2.2 Average Command

Resources that can be improved through mid or long-term investment by the company.

6.2.2.1 Internal Organization of the Company

Companies are organizations or "collective entities deliberately constructed in view to reach certain objectives, by coordinating resources [including Law] and actions".[14] This mode of organization plays a crucial role in the implementation of any legal action. For example, the legal department in banks is too often confined to a support function and is usually separated from the commercial departments. Files will only be transferred to the legal department when certain qualitative or quantitative thresholds are met. (The same is true of stakeholders in traditional companies). Thresholds can also be on the cognitive level. For example, only decisions considered as strategic will generally be verified *ex ante* by the legal department. The result is that there are two laws: "small law" which is applied by commercial departments and is not so much defined by current legal norms but rather in light of internal memos and manuals written by the legal department (the

[11]S. Woog, *La Stratégie du Créancier* (Dalloz, 1997) [Woog].

[12]See discussion in L.M. LoPucki and W.O. Weyrauch, "A Theory of Legal Strategy", an edited reprint in this text at Chap. 4.

[13]This is the other side of the "spotlight regulation" coin. See discussion on spotlight regulation in A. Masson, "The Origin of Legal Opportunities" (2009), Chap. 3 of this text [Masson].

[14]J. Chevalier, *Science Administrative* (Puf, 2002).

content of which is not always well understood) and "big law" which is implemented only when the legal department obtains access to the file.

In the same way, when certain qualitative or quantitative thresholds are met, companies will also take recourse to outside help, such as law firms. Most often, these externalisation thresholds are defined by the size of the company and the self-perception of the company when evaluating its own internal capacity to handle the problem. Indeed, companies may sometimes develop internal competencies in order to, among other things, save money given the high cost of expertise and experts.

6.2.2.2 Legal Form of the Company

The legal form of the company has a direct influence on its legal resources. For example, a cascading structure can allow the creation of entities which can shield the holding from certain legal attacks.[15] Conversely, if the organization is structured as a stock company, there is a risk that it will be threatened by extortion strategies. For example, small shareholders can exert judicial pressure to force the company to buy out their shares at several times their value. Moreover, some organizations, like professional associations, are endowed with broader legal standing than other organizations which can be useful in the implementation of procedural strategies. Co-operative forms of companies also benefit from a better image than limited companies which can be useful in drawing public attention. Sometimes, the use of a non-governmental organization form instead of a partnership, for example, can also be more advantageous for lobbying strategies as it gives the impression of the pursuit of a general interest goal.[16]

6.2.2.3 Access to Information and Legal Expertise of the Company

Information is the *sine qua non* condition of any strategy. Indeed, implementing a strategy implies an in-depth knowledge of Positive Law. One must also not forget that any analysis concerning quality of information is dependent upon the know-how of the lawyers of a given firm. One can in fact observe that knowledge management is linked to the size and activity of the company because size and activity determine a company's capacity to access information. Information is also a tool in the realisation of strategies because law is more often referred to rather than actually used.

Nevertheless, information can also become useless when it is used. For example, strategies aimed at intimidation or based on optimisation due to the haziness of

[15]C. Champaud, and D. Danet, *Stratégies Judiciaires des Entreprises* (Dalloz, 2005).

[16]Non-governmental organizations can be advisory members to international organizations such as the United Nations.

the law[17] become pointless when the issue comes before and is clarified by a judge. Further, we can see that companies may have an interest in investing in the legal information acquired by other companies and thus have an interest in the legal capital of those companies. Thus, Cetelem, a French company that deals with consumer credit, created a training program for outside intervening parties like bailiffs and lawyers. Indeed, the company deals with a large volume of litigation which typically ends up before a judge. Required by law to resort to legal auxiliaries, the company decided to train them itself and promote the exchange of experiences in order to increase its own profitability.[18]

Lastly, affiliations with professional associations also play an important role in influencing a company's decision to invest in legal capital as such affiliations tend to increase a company's awareness of the legal aspects of what is at stake.

6.2.2.4 Relationship with Stakeholders and Relational Network

The nature, scope and extent of a company's economic relationship with its various stakeholders can be crucial in that it can allow the company to transfer some legal risks to third parties or at the very least, minimise them. For example, arbitration provisions can be inserted into consumer contracts to avoid class actions.[19] A close relationship between companies can allow firms to share resources such as expertise. It can also allow them to orchestrate artificial litigation in order to create favorable precedent[20] or, at minimum, judicial appreciation of a factual situation that will bind another jurisdiction. Moreover, relationships can allow for the creation of specific strategies. One of the most widely known examples of strategy in Labor law is aimed at avoiding protection for an undetermined term employment contract and requires a relationship between two firms. This strategy typically involves small firms where a first manager asks a second firm's manager to offer a better position to one of its own employees. In most legal systems, when a worker is hired he or she must pass a probationary period before receiving the full protections received by undetermined term contract workers. So, in this situation, the second manager, having lured the employee over to the new position, will hire and then fire the employee before the expiration of his or her probationary period. The result is that the first firm does not have to pay the full damages that would normally

[17]For further discussion on optimisation through hazy law, see Masson (n 13).

[18]Example provided by Thibault du Manoir de Juaye, *Le Droit pour Dynamiser votre Business* (Edition de l'Organisation, 2004) 20 [Thibault du Manoir de Juaye].

[19]See discussion in M.J. Shariff, M. Pomrenke, and V. Hilder, "Perspectives of Legal Strategy through Alternative Dispute Resolution" at Chap. 9 of this text.

[20]For example see the European Court of Justice (ECJ) case *Werner Mangold v. Rüdiger Helm* (2005) Case C-144/04, where two lawyers orchestrated a litigation proceeding to determine if a specific EC Directive could produce an effect in a litigation that opposed two private parties (vertical direct effect), where a directive previously only produced a horizontal direct effect, i.e. between a private party and a member state.

be required but only has to indirectly pay the second firm for the first month of wages that it had to pay to the evicted worker.

6.2.2.5 Capacity to Attract Media Coverage

Certain activities, such as those that have a direct connection with the general public (like consumers) have a strong capacity to attract attention from journalists and the media. This capacity can be an asset, as seen with lobbying strategies, but it can also be a liability. By way of example, the French restaurant chain Buffalo Grill encountered financial difficulties when consumers deserted them due to a groundless complaint for the illegal import of meat from Great Britain during a European sanitary embargo.[21]

For some types of business, the capacity to attract media coverage during litigation can increase the aggressive reputation of a company and thereby increase its negotiating power. Such an ability could also have a positive impact on consumer perception of the company's reputation, regardless of the action's success, if the firm is able to demonstrate that it is acting for their benefit – for example, when it initiates litigation against a state monopoly or a specific regulation – and argues that if successful, it will decrease prizes in this sector. Furthermore, such ability could allow a firm to use litigation as a signal of its policy to a competitor and thereby indirectly facilitate certain coordination between them on a specific market.

6.2.3 Strong Command

Resources capable of being mobilized at any moment, if available.

6.2.3.1 Financial Resources of the Company

Any strategy obviously requires financial investment, even if only to secure the services of experts. Hence, cost can be used as a pressuring tool. A great number of legal strategies, because of legal uncertainty, involve the threat of legal proceedings as a negotiation tool. Indeed, a trial often constitutes a waste of time and money for the opposing party, irrespective of whether they are right. This is why a financially healthy company is a better target for strategic claims.

[21]For example see BBC News, "French Restaurant Chain in BSE Probe", online: BBC News http://news.bbc.co.uk/2/hi/europe/2590827.stm.

6.2.3.2 Time

Time is a crucial factor in all strategies. It can cause foreclosure and forms the basis of statutes of limitations, both of which also impose sanctions on the conduct of the plaintiff. Thus, time must be guarded in order to avoid the insolvency of debtors, for example. In the race to be paid before the insolvency mechanisms kick in, the one who comes first is always better positioned than the one who comes second. Anticipation[22] allows for a pre-emptive gathering of evidence. Indeed, debtors frequently drag out the fulfillment of their obligations, counting on the lassitude of their creditors or what Karl Van Clausewitz and Hans De Delbrück called the strategy of annihilation or the strategy of rampant wearing-out.[23]

Time summons creditors to be alert to the length or abuse of a procedure and the ways from which to escape performance, because time will impose sanctions on those that are sleepy through, for example, the effects of foreclosure, extinction or voiding the character of an action and thereby also rewards those who put them to sleep. It forces creditors to adopt preventive actions like adding guarantees to their contracts. It is also a vector of legal evolution and speculation. In France, the publication of over 3,000 new laws annually creates a multiplicity of legal conflicts and power imbalances that are open to exploitation. Thus, it is not rare for some companies to adopt practices based on a deregulation scheme before it has even become law on the assumption that it will.[24] Further, initiating a strategy is always uncertain with its effects perceived or produced only years later. Finally, time can also serve as an obstacle to the effectiveness of certain strategies because it does not allow for the anticipation of the content of a norm. For example, competition law takes into account market shares which ebb and flow according to the fickleness of consumers.

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[22]As the Romans said: *Si vis pacem, para bellum*: if you want peace, prepare for war.

[23]As quoted by Woog (n 11).

[24]For example, major foreign companies (as well as local) have recently started to offer online money games in France despite the fact that under current French law, only a limited number of firms have the legal right to operate such activities. These foreign companies base their behavior on the expectation that France will at some point be obliged to change its legal system in order to comply with EC law. If this analysis turns out to be correct, the strategy employed will be very beneficial for these firms as they currently do not have to share the costs borne by the monopolistic companies in return for their special rights. For example, the company that organizes horse racing bids is obligated to finance the racecourse. Consequently, any free rider firms are able to use the "extra" income to consolidate their competitive position before official deregulation of the sector. When deregulation eventually occurs, the costs previously supported by only the former monopolistic firm will have to be shared by all the economic players. So, if the first challenger to a norm takes on the risk that a court will ultimately rule against him, it has also had the advantage of having been the first new entrant in case of deregulation, which will generally be at a lesser cost than that incurred by a later post-deregulation entrant. Moreover, the free rider firm can also benefit from a positive image that might be attached to it by consumers who see the firm as acting in their interests. Lastly, if the numbers of firms adopting such free rider behavior are significant, the cost in justification and enforcement for a State to maintain such provision will increase accordingly.

6.3 The Decision to Invest in Legal Capability

For a company, the assessment of its legal capability is essential to the evaluation of the allocation of legal power on a market as well as the defining of efficient legal policy. Indeed, legal strategies are more likely to occur if fewer firms concentrate a large amount of legal capability over a larger number of competitors. Generally speaking, the biggest business players are also likely to be the biggest legal players. Indeed, if any legal capability is not entirely related to business assets (for example the existence of privileged legal positions occurs most often when companies are small), some key factors in the definition of the legal capability could be improved by spending economic resources. In most cases, a company's decision to invest in its legal capability is tempered by its assessment of the pros and cons of externalising a legal problem when the expenditure might be necessary for the company to stand up to its trade partners or in respect of its regulatory obligations. For example, is it more appropriate to hire a jurist to draft a commercial contract in some situations and in others to go to a law firm? Regardless, there are still other elements that influence a company's decision to invest in its legal capability.

6.3.1 Market Characteristics

The normative and economic environment surrounding the market clearly plays a major role, as it determines both the legal opportunities available to the company[25] as well as constraints. For example, companies that have a small margin but high volume will more likely need to maintain a low level of stock. In the same way, the existence of a close relationship with the clients of a company will usually mean that an amicable resolution of a potential conflict will be preferred. Conversely, the internationalisation of the activities of a company will tend to increase its need for legal capital. Moreover, technical norms can also limit recourse to the law by reducing the uncertainties in the language of certain contracts. In the same way, certain sectors use alternative modes of dispute management based on, for example, good name or reputation-based systems.[26] Such private ordering relies on practices which differ from "official" law and require specific knowledge.

[25]R.P. McAfee, H.M. Mialon, and S.H. Mialon demonstrate in their article, "Private Antitrust Litigation: Procompetitive or Anticompetitive?" that "Antitrust lawsuits by non-dominant firms against dominant firms are more likely to be strategic abuses of the antitrust law than law suits by dominant firms against non dominant firms". See R.P. McAfee, M. Mialon, and S.H. Mialon, "Private Antitrust Litigation: Procompetitive or Anticompetitive?" (2005) Emory Law and Economics Research Paper No. 05-18, online: SSRN http://papers.ssrn.com/sol3/papers.cfm?abstract_id=784805.

[26]Conversely, some markets are more judiciarised than others, for example the real estate market.

6.3.2 Activity of the Company

The nature of the company's activities can be particularly crucial. Indeed, some activities like nuclear energy are organized through long term contractual relations. Law is not seen in that case as a constraint or a necessity, but as a tool to manage change. Thus, contractual amendments are regularly signed on building sites to mirror their evolution. Moreover, some activities require legal expertise that can only be developed internally given the lack of available external expertise, as observed in the military industry. The situation is also generally the same, when law plays a crucial role in a company's business plan, for example, patent law for R&D companies or distribution law for franchisers.

6.3.3 Legal Environment

The legal environment plays a part in the decision to invest or not to invest in legal capability.[27] For example, the possibility of acquiring insurance to cover legal risks will usually reduce investment.[28] In that respect, the over-protection of parties that are considered weak, such as consumers, discourages companies to invest in legal capital.

6.3.4 Current and Past Events

Media focus on a specific problem or "spotlight regulation"[29] has the tendency to compel companies to invest in a particular area. For example, in the 1990s, Matra decided to train its executives in the knowledge of legal risks following the publication of articles in the press concerning embezzlement.[30] Past legal difficulties can also play a role in the decision of a company to invest or not to invest in legal capital. These can be the company's own difficulties or those of a third party which had consequences for the company such as the bankruptcy of a client.

[27]T. Côme, and G. Rouet, *Les stratégies juridiques des entreprises* (Editions Vuibert, 1997) 16.

[28]Of course, while we have mentioned that the existence of certain legal protections is a component of legal capital; this does not mean that the beneficiary of such protection will always invest in legal resource. This is likely because he or she is often not aware of such advantage.

[29]See Masson (n 13).

[30]See example by Thibault du Manoir de Juaye (n 18) 19.

6.3.5 *Level of Managerial Awareness*

Another key element is the level of awareness of the manager(s) which will often be dependant on his or her academic background and/or the risk of personal responsibility. Indeed, when a manager, as an individual, runs the risk of being held personally liable under fairly broad conditions, he or she will most certainly become more involved in guaranteeing the efficiency of his or her legal department. Moreover, any involvement of a company in the normative process, through such things as market surveys, the implementation of law or private enforcement, can also increase the company's interest in law and thus stimulate its investment in its legal capability.

6.4 The Decision to Take Legal Action

Some factors drive companies to invest in legal resources in order to acquire a competitive advantage or to prevent competitors from using legal strategies against them. However, these factors should not be confused with the reasons that drive a firm to take legal recourse or action. Unlike the latter, which might be seen as reactive, legal resources determine the capacity of a company to: understand its legal environment; analyse advantages that might be drawn from legal pathologies; and correctly implement the chosen strategy.[31] Regardless however, legal resources must be mobilized to set things in motion. While it is difficult to predict the outcome of a legal strategy or even to evaluate the advantages that might ultimately be obtained,[32] the following four elements can be identified as being relevant to a firm's decision to take legal action:

6.4.1 *Cost Calculation*

Before undertaking any legal action, a company needs to conduct an economic evaluation. This is generally done by comparing the economic and reputational costs and benefits of a judicial action, evaluating the merits of a particular legal regime (for example the merits of the limited form or public form company regimes), or even evaluating the benefits that might be drawn from strict legal compliance.

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[31]While there may indeed be a number of eventual legal needs, individuals may ultimately prefer to not resort to legal means. See discussion in E. R. Blankenburg, "La Mobilisation du Droit: Les Conditions du Recours et du Non-recours à la Justice" (1994) 28 Droite & Societe 691–703, online: http://www.reds.msh-paris.fr/publications/revue/html/ds028/ds028-13.htm [Blankenburg].

[32]As it is often difficult to predict a trial outcome, any judicial threat can be used in negotiation or to threaten a competitor.

6.4.2 Perception of Law

Several authors have analysed the company perception of law in order to explain companies' level of integration of the legal function. For example, Halfon places the company perception of law into three levels or categories: a means of defence; a mode of regulation; and a technique of management.[33] Thierry Côme and Gilles Rouet discuss the firm's perception of law as four types of reactions to law:[34]

- Companies that neglect law. For example, companies that only act on a local market.
- Companies that consider law as an external constraint. Here the company only evaluates whether its choices are compatible with the law.
- Companies that demand law, in order to, among other things, maintain their position on the legal market through standardisation for example.
- Companies that look for legal opportunities and use strategic planning schemes.

Finally, Paillusseau distinguishes two possible roles for the jurist:[35] on the one hand, the man that drafts legal agreements and whose presence is deemed as a necessity to enhance the company's legal compliance, and on the other hand, the man who is a partner in the strategy of the company, who contributes to its development and is considered to be an investment rather than a cost. Indeed, the view of law taken by a company,[36] i.e. whether it perceives soft, flexible, hazy or crazy law[37] as a strength or a weakness, is equally important in the decision to implement a strategy.[38]

The perception of law and consequent implementation of a strategy also involves analysis of: the legal arguments and motives of the adversary; the environment; time constraints;[39] the image generated by legal proceedings; and the legal tradition

[33]See thesis by L. Halfon, *Le Droit et l'entreprise: Bilan et Perspective*, (1986) Paris I, as quoted by P. Philippart in "Proposition d'une Approche de la Gestion Juridique en Termes de Marge: Caractéristiques et Implication", (2000) Working Paper, CLAREE-IAE Lille Juin 2000, online: Université des Sciences et Technologies de Lille http://www.univ-lille1.fr/bustl-grisemine/pdf/rapports/G2000-173.pdf.

[34]See T. Côme, and G. Rouet, *Les stratégies juridiques des entreprises* (Vuibert, 1997) 7 and discussion of work by F. Gallouj.

[35]See J. Paillusseau, "L'avenir du Juriste d'affaire" (4 Mars 1994) 27 LPA.

[36]According to Pierre Bourdieu, "characteristics inherited from the social trajectory, like 'rigorism' specific to the bourgeoisie, condition the attitude towards the rule". See P. Bourdieu, "Droit et Passe-droit. Le Champs des pouvoirs Territoriaux et la Mise en œuvre des Règlements" (Mars 1990) 81/82 Actes de la Rechercher en Sciences Sociales, 88.

[37]See Masson (n 13).

[38]According to E. R. Blankenburg, a trial only concerns the persons who already have an idea of what judicial proceedings mean. See Blankenburg (n 31) 691–703.

[39]See Woog (n 11).

of the forum rei.[40] That being said however, the perception of law is not the only criteria involved in the choice of recourse to it.

6.4.3 Configuration of Law and of Legal Opportunities

The ways in which each element of the normative environment and of legal capital can influence legal strategies must also be analysed in light of the legal environment of each company. For example, Luxembourg is widely known for its tax advantages, hence it might actually be more beneficial for a small company to move to France where it can benefit from better qualified and cheaper labor. If we take the example of normative competition, companies can indeed decide to transfer their activities in order to gain from an environment perceived as more beneficial (voting by foot) but they can also try to change their current environment to their advantage (voting by hand). Even if a company decides to move, it will still need to establish certain criteria in order to be able to determine the most efficient environment. If we take the example of labor law, there are two types of normative environments. The first environment allows for highly developed labor law where a company needs to accept a regular and higher cost of social protection in exchange for protection from the risks that arise from this social relationship, i.e. conflicts, turn over and accidents. Alternatively, the second environment allows for lower social costs but then the company will have little protection from related risks. The choice to be made here is one of either collectivisation or individualisation of risks. Here the company will have to make a cost–benefit analysis of the protection conferred and take into account the risk of occurrence, i.e. low continuous costs or high random costs.

6.4.4 Respect of Law's Characteristics

Even if legal strategies do indeed play on certain pathologies of law, it is still likely the case that certain characteristics of law itself, such as predictability, continue to play an important role. The legal actor that implements a strategy must make certain that the techniques at the heart of its realisation are reliable and that they are enforceable in the local legal system. This remark is also applicable to the characteristics of law. Indeed, when a contractual strategy is put in place, the party expects the advantage to become a legal reality. Thus, a norm suffering from all the pathologies would be of no use for the implementation of a strategy. One can thus wonder if the possibility of having recourse to strategies is therefore not a way to shape the conduct of companies and attract them towards legal areas. Therefore, in addition to the savings in the transaction costs that it allows, it appears that

[40]American pragmatists are particularly sensitive to the legal actors' opinion(s) of the situation at hand.

companies also respect the law all the more readily so that they can use it in pursuit of their strategic goals.

6.5 Conclusion

Because of law's pathologies and legal resources, companies have the opportunity to develop economic comparative advantage. However, this opportunity might only be available to those companies with the legal capability to exploit these pathologies and/or resources. In this context, it is crucial for companies to evaluate both their own legal capability regarding the probability of success of their vertical strategies (i.e. strategies mainly detrimental for a public authority such as a tax avoiding schemes which can indirectly lead to a comparative advantage) as well as the legal capability of their competitors, when they are considering the implementation of horizontal strategies (i.e. strategies directly detrimental for the competitor such as rising cost strategies by abuse or use of competition law) or when they think that they might be the target of such strategies.

Legal capability is thus a central concept to any legal relationship and must be considered in order to prevent fair legal relations from degenerating into exploitive contracts. Decision makers should also take legal capability into consideration before adopting statutory instruments. Indeed, it would be misguided to believe that the creation of a homogenous level playing field through any process of harmonisation of national legislations could lead to a decrease in strategic opportunities. To the contrary, it has in fact favored first and foremost the most globalised companies by stripping smaller companies of the possibility of practicing, for example, forum shopping – a much less costly technique in terms of legal resources – while allowing larger companies to practice other types of strategies, such as lobbying or creation of subsidiary companies for activities presenting more risks. Indeed, legal capability is one of the determinants of any legal strategy. Accordingly, before initiating any legal action, a firm would be wise to carefully evaluate the legal capability of any stakeholders that might have a part to play.

Chapter 7
Litigation Cost Strategies from Economics*

Rupert Macey-Dare

Abstract Starting with a simple economic model of the value of civil litigation from each side's perspective, this paper analyses a wide range of potential litigation cost strategies, settlement offers and negotiations, together with relevant applications and insights from game theory. Specific issues examined include: optimal settlement agreements, optimal settlement timing, optimal choice of lawyers; principal–agent problems aligning lawyer cost incentives; optimal client–lawyer contracts; "Conditional Fee Agreements" (CFAs); success rules and size of success premia; the exploitation and mitigation of liquidity and bankruptcy constraints; impact of collateral, "Security for Costs" and "Freezing Orders"; optimal "Part 36 Offers"; public and "without prejudice" offers; fixed rate and state-contingent offers; the role of mediation and alternative dispute resolution (ADR); the effect of litigant group size, co-ordination and class actions; rationale for confidential no-liability settlement agreements; effects of legal aid; time-value to trial and "optionality" of news; the impact of the "Law of Costs"; optimal trial cost applications and requests for "leave to appeal". Both familiar and paradoxical new results are confirmed by the analysis.

7.1 Introduction

Starting with a simple economic model of the value of civil litigation from each side's perspective, this paper analyses a wide range of potential litigation cost strategies, settlement offers and negotiations, together with relevant applications and insights from game theory. Specific issues examined include: optimal settlement agreements, optimal settlement timing, optimal choice of lawyers;

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principal–agent problems aligning lawyer cost incentives; optimal client–lawyer contracts; "Conditional Fee Agreements" (CFAs); success rules and size of success premia; the exploitation and mitigation of liquidity and bankruptcy constraints; impact of collateral, "Security for Costs" and "Freezing Orders"; optimal "Part 36 Offers"; public and "without prejudice" offers; fixed rate and state-contingent offers; the role of mediation and alternative dispute resolution (ADR); the effect of litigant group size, co-ordination and class actions; rationale for confidential no-liability settlement agreements; effects of legal aid; time-value to trial and "optionality" of news; the impact of the "Law of Costs" (LOC); optimal trial cost applications and requests for "leave to appeal". Both familiar and paradoxical new results are confirmed by the analysis. Both familiar and paradoxical new results are confirmed by the analysis. Specific examples are considered from the law and practice of England and Wales but the fundamental principles derived are applicable, mutatis mutandis, to all other related legal systems including American and Commonwealth.

7.2 Analytical Framework and Model Setup 1

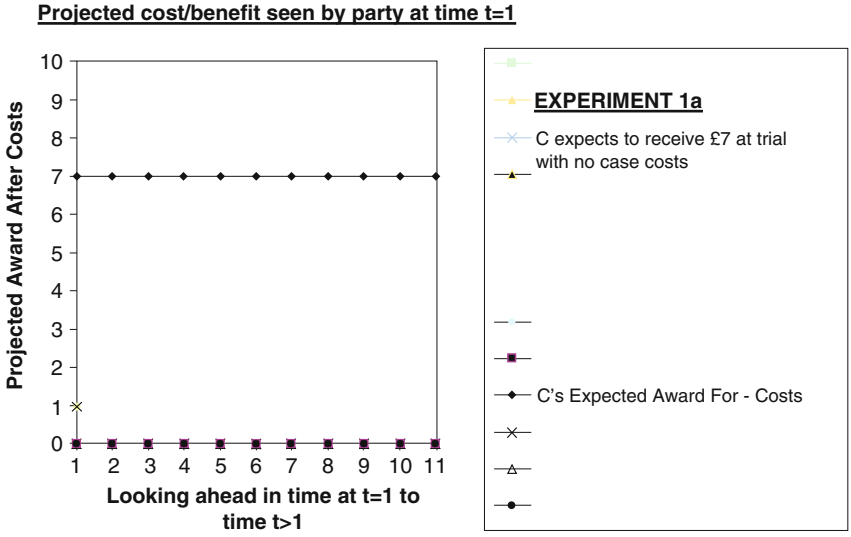
The main conceptual model used in this paper is constructed in Sects. 7.3–7.5. It is built up from the subjective expected legal costs and cost variability perceived by each party, contemplating new or continued litigation, all adjusted for risk premia and liquidity considerations. This information is embodied for the Claimant C in his "Settlement Acceptance Frontier" or SAF and for the Defendant in his "Settlement Offer Frontier" or SOF, considered prospectively at each point in time. Whenever these curves overlap, at intersection point X, with a region of SOF lying above a region of SAF, then there is immediate scope for settlement before trial, somewhere around the X value. Similarly, with imperfect information, whenever a party believes that these curves might overlap, then there is scope for exploratory settlement negotiations. The analysis of the paper is primarily graphical in order to be intelligible to the widest audience. The particular numbers used in the examples are purely illustrative, although corresponding real world curves can be estimated and calibrated and would clearly need to be, in real litigation situations. Similarly, the diagrammatic and theoretical analysis below can be replicated using comparative static and other mathematical techniques. The analysis of this paper is based on consideration of a simple example dispute: namely proposed litigation between parties, Claimant C and Defendant D over a notional £10 claim. The general results derived below apply equally to high and low value and complex and simple litigation processes.

7.2.1 First Scenario: Zero Legal Costs and Zero Risk Premia

In the first scenario, litigation costs for all parties are preset at zero and both parties ignore risk, i.e. have zero risk aversion and zero risk premia, C's claim is for £10.

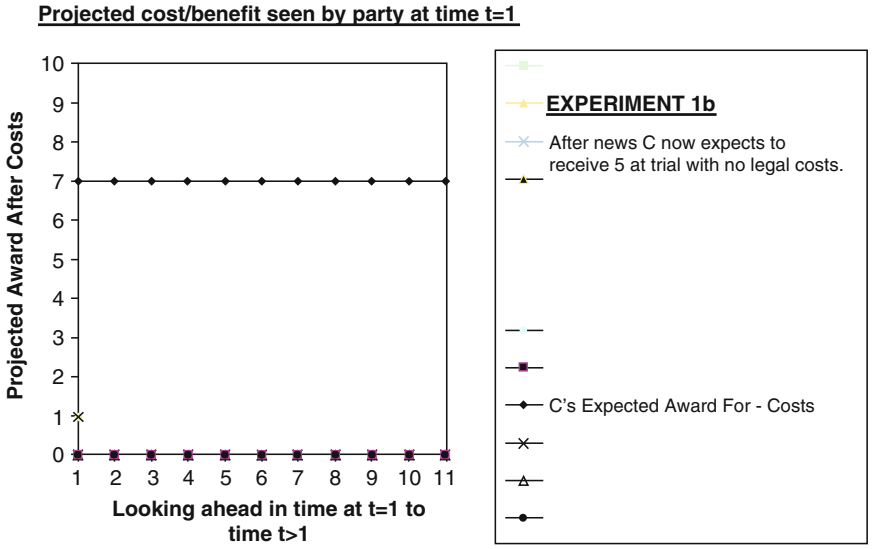
7.2.1.1 First Scenario: Party C Only

C's expectation at initial time $t = 1$ is to receive £7 at trial. In the absence of costs, looking ahead from $t = 1$ to the projected end of the case at $t = 11$, C expects that he will continue to expect to receive £7, because if he expected to receive a different amount at time $t = 11$, then working iteratively back, he would logically expect to receive that different amount at time $t = 10$, then at $t = 9$, etc., back to $t = 1$. This situation is shown in Fig. (1a):



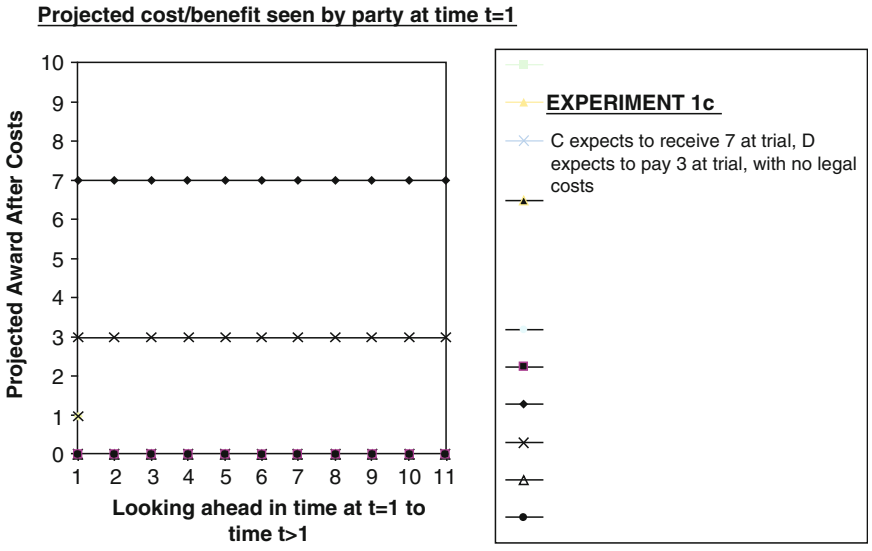
Thus C's forward subjectively expected gross trial payoff at any time t, as seen from fixed time $t = 1$, is itself momentarily fixed. That is not to say that C is objectively correct or unchanging in this expectation. C's information may well be wrong and he may eventually receive a totally different sum at trial. C's beliefs may also change suddenly in response to new information, for example C may suddenly and unexpectedly get new information that his expected payoff at $t = 11$ has fallen to £5. In this case C's new expected gross trial payoff seen from $t = 1$ would have fallen to £5 as shown below in Fig. (1b):

Thus in the absence of legal costs and risk premia, the projected subjectively expected gross cost/benefit line of each party as contemplated at any fixed moment will be flat for every future moment surveyed until trial. On the other hand, this subjectively expected gross cost/benefit line will itself shift randomly up and down in parallel over time in response to random news relating to prospects at trial.



7.2.1.2 First Scenario: Parties C and D

In this example, litigation is free, i.e. litigation costs for all parties are preset at zero, both parties have zero risk aversion and zero risk premia, the claim is for £10. The initial expectation of Claimant C at initial time $t = 1$ is to receive £7 at trial and the initial expectation of Defendant D at initial time $t = 1$ is to pay £3 at trial. By the same logic as above, C's expectation at $t = 1$ of his future expected gross trial payoff perceived at all times $t = 2$–11 is constant at £7, similarly D's expectation at



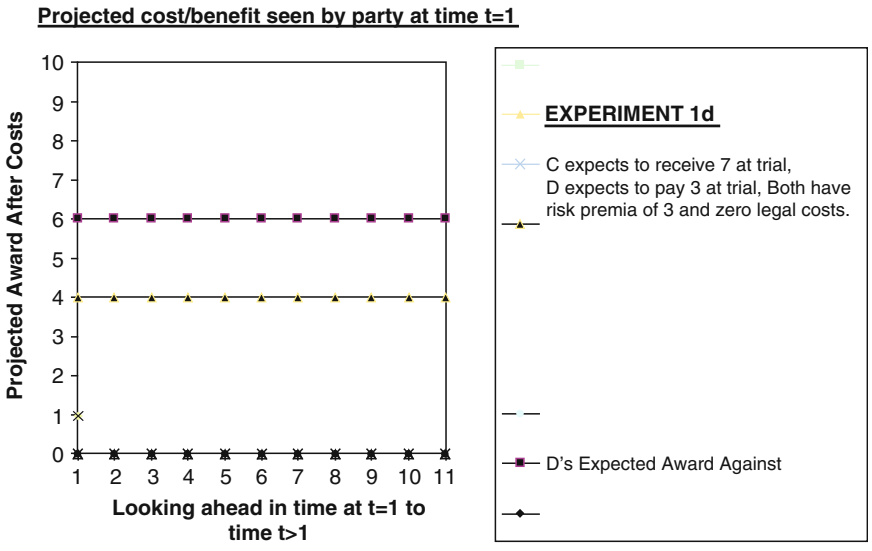
t = 1 of his future expected gross trial payoff perceived at all times t = 2 to 11 is momentarily constant at £3. The reason why C and D do not agree is because each of their expectations are subjective, each based on that individual's own information and beliefs. This situation is shown in Fig. (1c):

7.2.1.3 Scope for Settlement in First Scenario

In the first scenario where C expects to receive £7 from trial and D expects to pay £3 at trial, with no legal costs and no risk aversion, it looks at first, as though C and D will not be able to agree to settle before trial. There are two reasons why this may be wrong in practice. Firstly as C and D receive new information or recalculate their odds, so their expected payoff/payment lines will shift up and down. This process is random by definition and so the more time there is until trial so the more chance there is that revision of mutual expectations will shift C's expected trial receipt line relatively lower than D's expected trial payment line.

7.2.2 Second Scenario: Zero Legal Costs and Non-zero Risk Premia

The other factor is that both C and D will typically be prepared to settle away from their expected trial payoff lines. Typically they will both be prepared to pay some premia to avoid the hassle and risk of trial and achieve early settlement, i.e. both will be prepared to pay "risk premia" to combat their natural risk aversion. Thus for



example if both C and D are prepared to pay risk premia of £3 to remove risk in the baseline example, then the maximum D will pay to settle is now £6 and the minimum C will accept to settle is now £4, leaving a range of agreeable settlements at $t = 1$, before trial between £4 and £6 as shown in Fig. (1d) below:

7.2.3 *Definition of Claimant's "Settlement Acceptance Frontier" and Defendant's "Settlement Offer Frontier"*

In this case C will be prepared to settle for any amount above his line of: own expected trial payoff plus own expected legal costs all adjusted for own risk premia, which can be called his "Settlement Acceptance Frontier" or SAF. It is a frontier because it is the border of a projected region of values where he can agree to settle. In example (1d) the SAF is flat at £4, being own expected trial payoff of £7 less expected own legal costs of zero, less risk premia of £3. Similarly D will settle for any amount below his "Settlement Offer Frontier" or SOF. In example (1d) the SOF is flat at £6 being own expected trial payout of £3 plus expected own legal costs of zero, less risk premia of £3.

7.2.4 *Lessons from Initial Model Setup and Analysis*

Some lessons can already be drawn from this initial model setup:

1. The more variable the expectations of the parties and the greater the flow of news, so the more likely are the SOF and SAF to overlap at some point and for settlement before trial to become possible.
2. The longer the case, ceteris paribus, the greater the likelihood of a settlement window occurring.
3. The more complex the case, the more likely lesson 1 is to hold, so the more likely that parties will be able to move towards settlement, ceteris paribus.
4. The parties can only identify the window when the SOF and SAF overlap by communicating, therefore it is essential to maintain frequent informal communication between parties throughout the litigation process.
5. The parties need to be able to identify the existence of an actual or potential SAF and SOF overlap. This does not however mean revealing the exact degree of overlap.
6. By communicating, both parties can gain information about the other party's SOF or SAF and spot the settlement window. Additionally the way in which the parties interact may in turn affect the other party's risk premia applied.
7. Each party has an incentive to try to increase the other party's risk premia, e.g. by trying to unnerve/intimidate the other party. This tactic both increases the

chance of possible settlement and the chance of the intimidator improving the final settlement from his own perspective.
8. Thus each party has to balance the need to gain information from the other side through communication and the need to try to intimidate the other party to weaken its position and increase the other side's risk premia.
9. If parties have differential power then the more powerful party can emphasise intimation rather than communication to increase the weaker party's risk premia.
10. Similarly the weaker party needs both to maintain communication and signal convincingly that he has not been intimidated and his risk premia have not increased.
11. The corollary of this is that the legal negotiators need to identify quickly whether there is differential power in the settlement negotiation and choose their negotiating stance accordingly.

7.3 Analytical Framework and Model Setup 2

7.3.1 Third Scenario: Non-zero Legal Costs and Zero Risk Premia

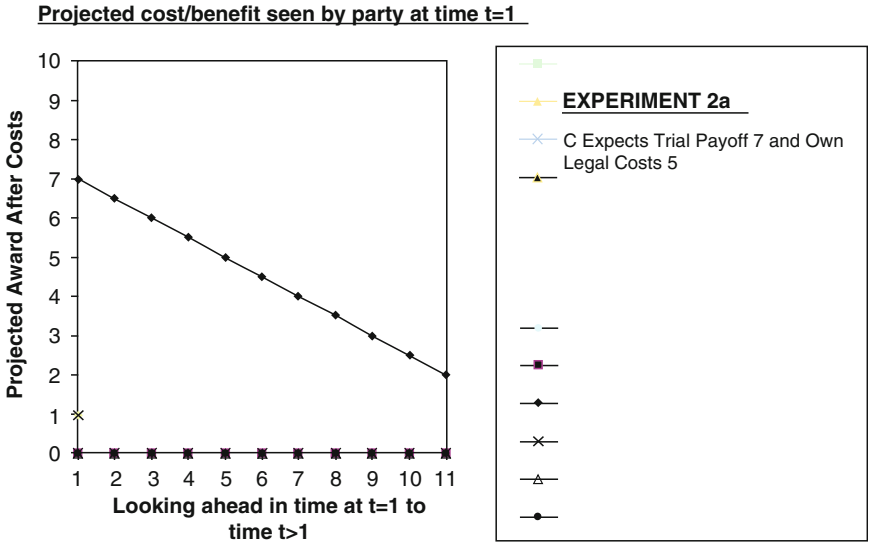
In the third scenario, non-zero legal costs are added. The simplifying assumption made is that both C and D expect these costs to occur smoothly and linearly over time. As in real life, legal costs can be shown to have a fundamental effect on the analysis of settlement:

7.3.1.1 Third Scenario: Party C Only

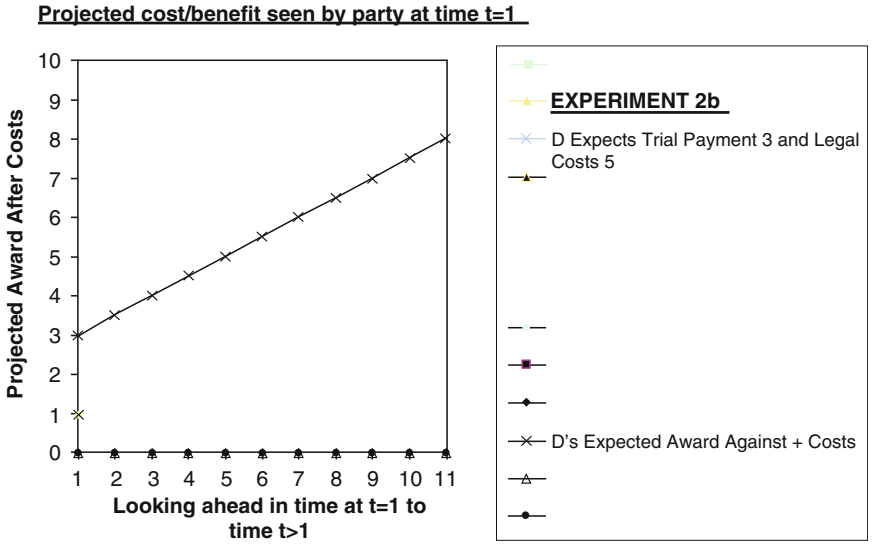
In the first example of non-zero legal costs, C looking out at time $t = 1$, expects to receive £7 at trial but to incur £5 of legal costs, incurred at constant rate between $t = 1$ and $t = 11$, to actually get to trial. Hence the net payoff C envisages at trial after costs is reduced by legal costs to £2. Since this is greater than zero, C still has an incentive not to abandon the case, but C realises that the earlier he can settle the more he can save in legal costs and the greater his expected net gain from the case, ceteris paribus. This is shown in Fig. (2a) below:

7.3.1.2 Third Scenario: Party D Only

In the second example of legal costs, the Defendant D looking out at time $t = 1$, expects to pay £3 at trial but also to incur £5 of costs, incurred at constant rate between $t = 1$ and $t = 11$, to actually get to trial. Hence the net cost of the trial that D envisages is increased by legal costs to £8. Since this is less than the £10 claimed by C, D still has an incentive not to abandon the case, but D also realises that the

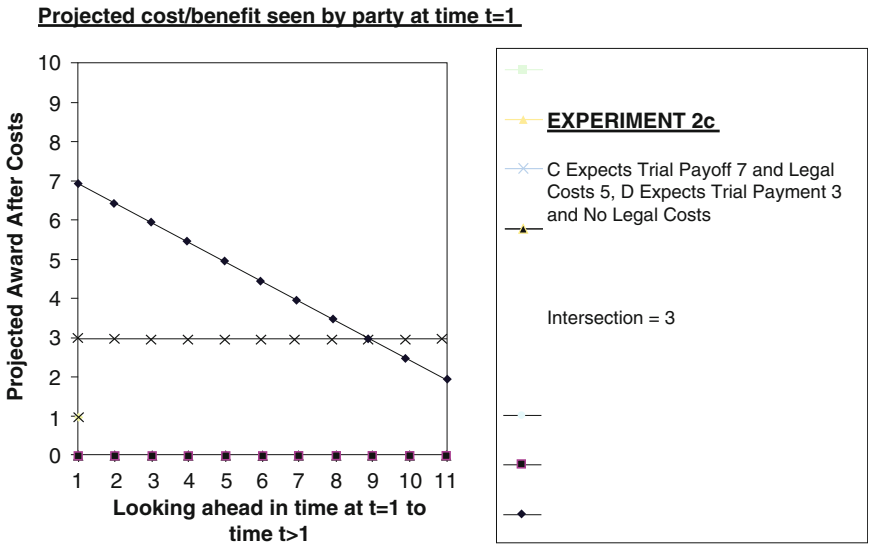


earlier he can settle, the more he can save in legal costs and the lower his expected net loss from the case, ceteris paribus. This is shown in Fig. (2b) below:



7.3.1.3 Legal Costs for Party C Not D

If Claimant C incurs linear costs but party D does not, then the SAF and SOF intersect at £3 and $t = 9$. By holding out to trial D expects his net payout to be £3 and C's expects his net receipt to be only £2.

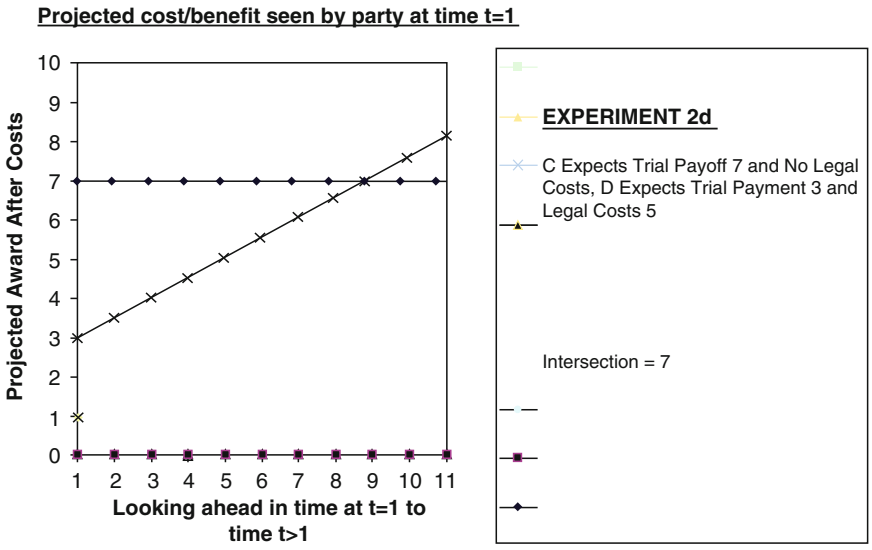


Since £2 is greater than zero and £3 is less than £10, both parties have an incentive to progress to trial, in the absence of settlement. However since D's maximum feasible settlement of £3 lies above C's minimum feasible settlement of £2 both sides have an incentive to settle before trial. It is important to recognise that this settlement agreement would occur only because the parties recognised their own interests to avoid legal costs and not because they agreed about the fundamental merits of the case. It is important also to recognise that if the SAF and SOF curves are known by both sides and if the expected trail payoffs on both sides are fixed, then the settlement condition of SOF lying above SAF will only persist for two time units until $t = 3$ (in the absence of legal cost awards, see later). The maximum sharable surplus, i.e. £1 being £3–£2 only occurs at $t = 1$. Put another way, when there are prospective legal costs (in the absence of legal cost awards) the earlier both sides can settle the more legal costs they can save.

7.3.1.4 Legal Costs for Party D Not C

If party D expects to incur legal costs but party C does not, then the SAF and SOF intersect at £7 and $t = 9$. By holding out to trial, C expects his net receipt to be £7 while D expects his net payout to be £8. Since £7 is greater than zero and £8 is less than £10, both parties have an incentive to progress to trial in the absence of settlement.

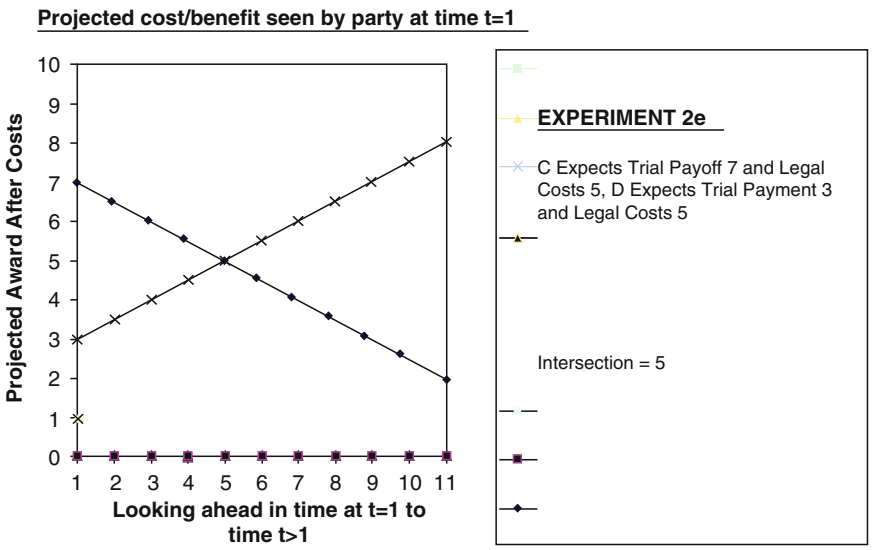
However since D's maximum feasible settlement of £8 lies above C's minimum feasible settlement of £7 both sides have an incentive up to time $t = 3$ (in the absence of legal cost awards) to settle instead of proceeding to trial. Once again, this settlement agreement would occur only because the parties recognised their



own interests to avoid legal costs and not because they agreed about the fundamental merits of the case.

7.3.1.5 Legal Costs for Both Parties C and D

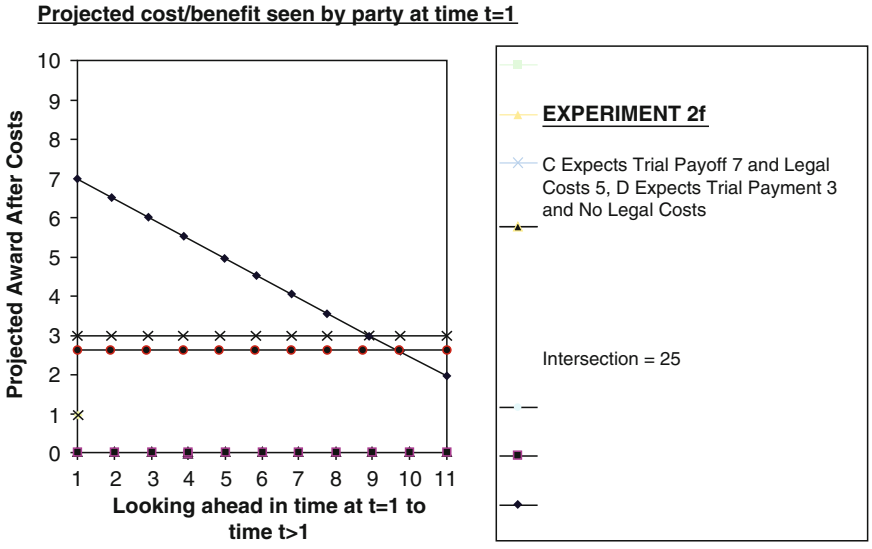
In the next example, Claimant C expects to receive £7 at trial and Defendant D expects to pay £3 at trial. Additionally each party expects to pay £5 in legal costs to get to trial.



C's expected gross return from going to trial is £2 and D's expected gross payout in going to trial is £8. Since £2 is greater than zero and £8 is less than £10, both C and D have an incentive to progress to trial, in the absence of settlement. The SAF and SOF curves intersection point X is at £5 and at time $t = 5$, after which point SOF lies above SAF and the feasible settlement condition holds. The range of feasible settlements viewed at $t = 1$ lies between £2 and £8. Moreover the closer in time each party focuses ahead to $t = 5$, i.e. the earliest projected settlement break-even time, so the closer any agreed amount will be to £5.

7.3.1.6 Benefits of Cheating re: Expected Court Award

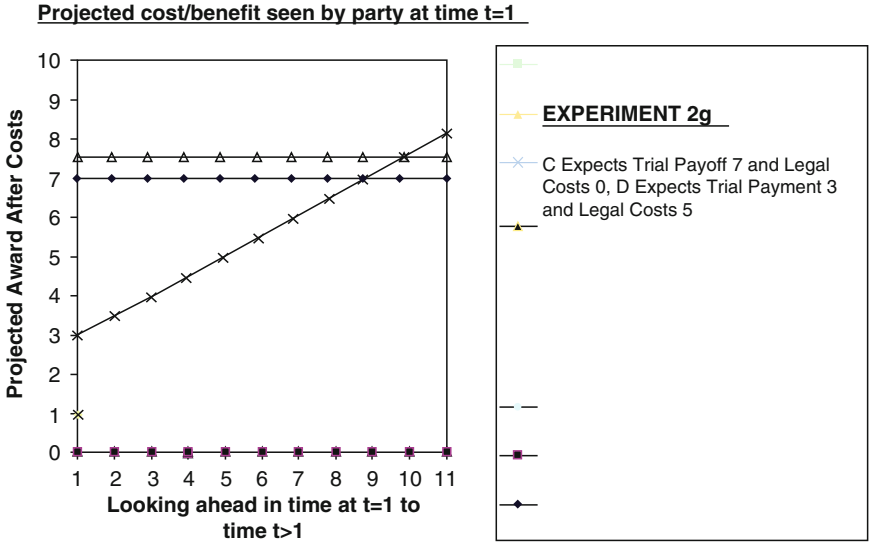
As shown above, additional legal costs tend to cause the SAF and SOF to intersect, i.e. to create a range of possible settlement agreements and scope for such agreement. However they also create an additional incentive for the parties to dissimulate the location of their SAF and SOF curves. This is illustrated in example (2f), being the same as example (2c) above except modified so that party D now pretends that his SOF curve is flat at £2.5 and not £3 as shown below:



If D cheats and both pretends and fools C that D believes that his own expected payout at trial will be £2.5 and not £3 then this pretence lowers the maximum feasible settlement before trial seen at $t = 1$, from £3–£2.5. It would still be advantageous to both sides to settle before trial at $t = 1$. When contemplating settlement, C would also be contemplating the breakeven alternative of more legal costs, therefore the settlement amount from C's perspective would have decreased ceteris paribus, on the basis that C can now envisage the case running

to $t = 10$ and his net payoff at that time (after subsequent settlement) being only £2.5 and falling further, if the case proceeds to trial.

Similarly consider example (2g) being example (2d) above modified so that party C now pretends that his SAF is at £7.5 not £7 as shown below:

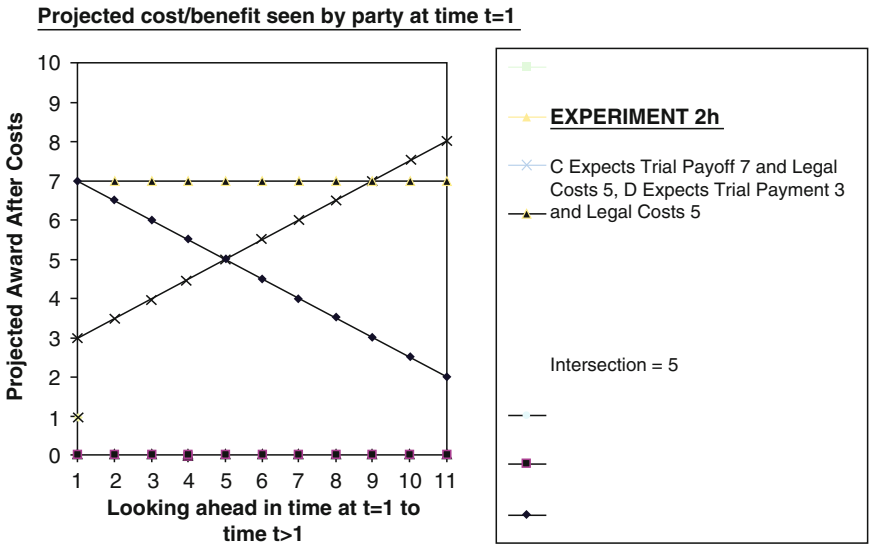


If C cheats and both pretends and fools D that C believes that his own expected payout at trial will be £7.5 and not £7, then this pretence increases the minimum feasible settlement before trial seen at $t = 1$, from £7–£7.5. It would still be advantageous to both sides to settle before trial at $t = 1$. When contemplating settlement, D would also be contemplating the breakeven alternative of more legal costs, therefore the settlement amount from D's perspective would have increased, ceteris paribus.

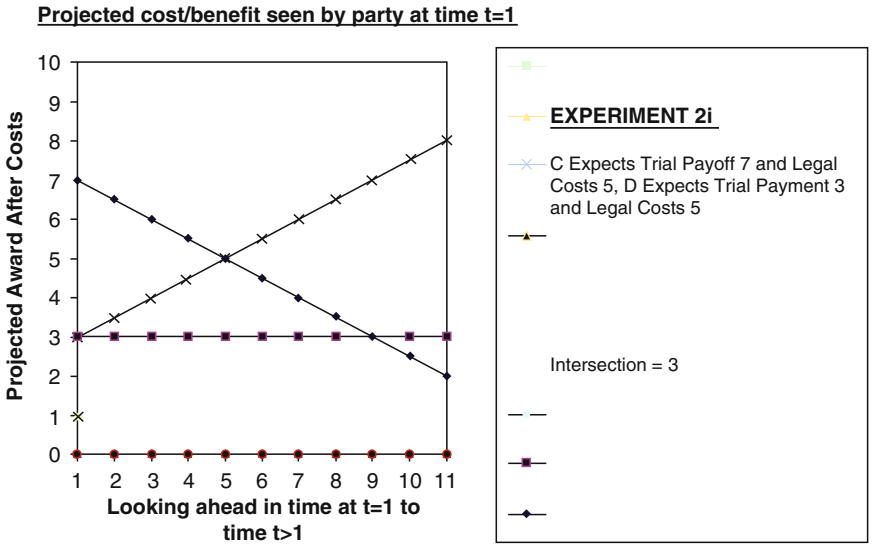
7.3.1.7 Benefits of Cheating re: Expected Legal Costs

Additional benefit can also be gained for settlement negotiation purposes by both sides cheating and dissimulating on expected legal costs. Thus consider example (2h) which is the same as (2e) with the difference that Claimant C now cheats and fools D that C faces no legal costs.

This cheating by C if believed by D, increases X, the intersection of SAF and SOF from £5–£7 and decreases the set of feasible settlements from £8–£2 instead to £8–£7. It will still be in D's interests to settle at £8 or below, but C's cheating on costs makes D project further ahead and envisage paying more legal costs at the breakeven settlement point and hence D expects to pay more in alternative prior settlement, ceteris paribus.



Similarly, consider example (2i) which is the same as (2e) with the difference that Claimant D now cheats and fools C that D faces no legal costs.



This cheating by D, if believed by C, decreases point X, the intersection of SAF and SOF curves from £5–£3 and decreases the set of feasible settlements from £8–£2 instead to £3–£2. It will still be in C's interests to settle at £2 or above, but D's cheating on costs makes C project further ahead and envisage paying more legal

costs at the breakeven settlement point and hence C expects to pay more in alternative settlement, ceteris paribus.

Thus each party has an incentive to pretend to the other side that he will do better at trial and incur less costs up to trial (in the absence of legal cost awards), up to the point where such pretence looks implausible or appears to preclude any feasible settlement before trial. Additionally each party has an incentive to make the other side perceive the highest possible level of own costs.

7.3.2 Lessons from Own Legal Costs Scenario Analysis

A number of additional lessons can be drawn from the simple linear costs scenario analysis:

12. Adding legal costs increases the scope for settlement ceteris paribus, because each party can project ahead and envisage the costs that both they will face if they do not settle and that the other party will face if they in turn do not settle.
13. Adding legal costs causes the SAF and SOF to close towards each other over time, as seen from fixed time point, if the SAF curve initially lies above the SOF at $t = 1$.
14. Adding increasing legal costs adds more urgency to settlement negotiations as the parties need to project less far ahead in time to see a benefit from settlement and additionally because the longer they wait the more legal expenditure can be incurred as a potentially sunk cost.
15. With no legal costs, there is an option time value to parties waiting on the off-chance that their prospects will improve, however as the projected legal cost become more extreme so the opportunity costs of waiting become more extreme and hence the optimal amount of time one might wait for developments falls.
16. Increasing legal costs on both sides could raise or lower the point of intersection X of the SAF and SOF and could thereby raise or lower any settlement agreement.
17. However increasing legal costs unequivocally reduces the time that both sides need to project ahead to see the benefits of settlement, ceteris paribus.
18. Both sides have an incentive to pretend that they will both do better at trial and also incur less legal costs, ceteris paribus, up to the point where this looks implausible or removes the set of feasible settlement agreements.
19. It is important that the client in private is not correspondingly beguiled by an over-optimism on own costs and likely outcome at trial.
20. Adding legal costs deters litigation both by encouraging prior settlement and by making litigation unprofitable in the absence of settlement, as discussed below.
21. The relative slope of the legal costs curves determines the importance for settlement of each side's beliefs and range of possible beliefs about the payout amount at trial as shown below.

7.4 Analytical Framework and Model Setup 3

7.4.1 Introduction and Impact of Risk Aversion

In reality, both sides are averse to risk and will pay or give up some amount of potential gain to avoid this. In other words they are risk averse and will consequently pay risk premia to avoid such risk. In the situation considered, the risk premia are particular to each client and will depend on background factors such as underlying financial resources and familiarity with the litigation process. If an uninformed client is not made aware of the risk factors then his risk premia may be much lower than they otherwise would be. This is dangerous since it might cause him to proceed with litigation or avoid timely settlement or settlement at the right level. The risk premia on each side are likely to vary in response to news and over the course of the case due to endogenous forces. Typically increasing risk premia will both decrease the gap between and steepen the SAF and SOF curves. The reason is that the more money risked in legal expenses, the more risk premia potentially payable to insure the effectiveness of those legal expenses. There is no fundamentals model of risk premia in this paper, but their effects are nevertheless vitally important and both sides have incentives to maximise the other side's risk aversion and risk premia, to closely monitor the other side's risk premia and to minimise their own perceived risk premia.

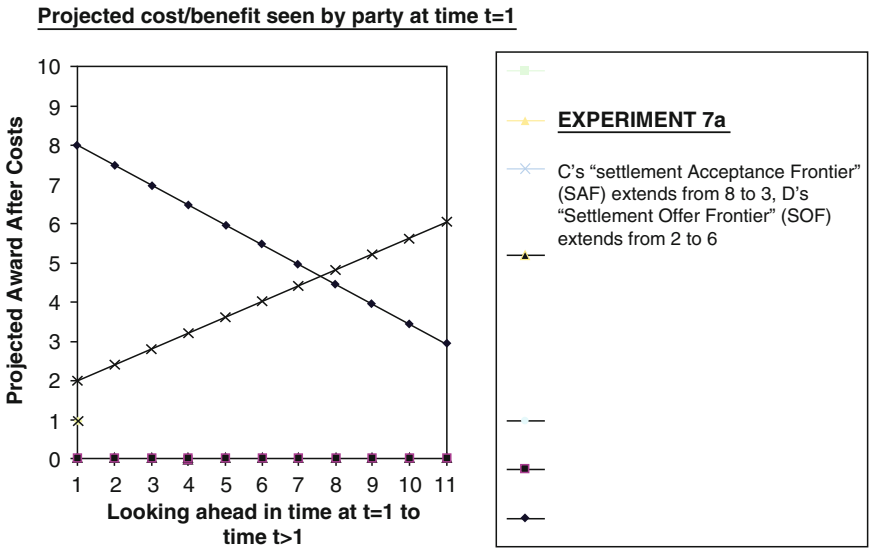
7.4.2 Agreeing a Settlement Figure from the Range of Feasible Agreements

As argued above, the Claimant C can be modelled as having a notional "Settlement Acceptance Frontier" or SAF at all points during a course of litigation. The SAF is the curve of minimum settlement amounts that C would be prepared to receive in return for dropping the case, when C momentarily projects ahead to the future course of litigation. Of course C would always be happy to accept more if offered and hence the SAF, provides information on the minimum and not the maximum that C would be prepared to receive, hence it is the lower frontier of an acceptable payoff region for C.

C's SAF is composed of three elements, namely C's subjectively expected payoff at trial, C's subjectively expected legal cost projections and C's subjectively perceived risk premia covering what C will give up in order to avoid risk components. The expectations are all from the perspective of C at the observation time, in other words, the expectations are consistent expectations based on C's perceived information set at time $t = 1$, the observation time.

Combining these elements, C's SAF will be a downward sloping curve, reflecting what C expects his net return to be as the case runs through to trial plus risk premia.

In Fig. (7a) for example C looking out at $t = 1$ expects his payoff at trial to be £9, his risk premia to be fixed at £1 and his legal costs incurred linearly between time $t = 1$ and $t = 11$ to be £5.

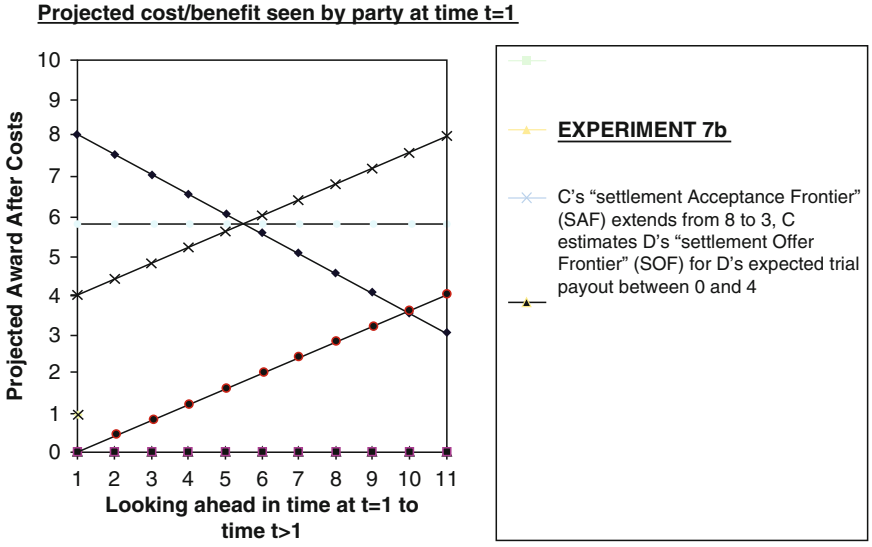


By an exactly parallel argument D's settlement offer frontier or SOF is built-up from his own expected payout at trial, his own expected legal costs and his own risk premia. Thus in Fig. (7a) D expects trial payout to be £1.5, his own risk premia to be fixed at £0.5 and legal costs incurred linearly between time $t = 1$ and $t = 11$ of £4.

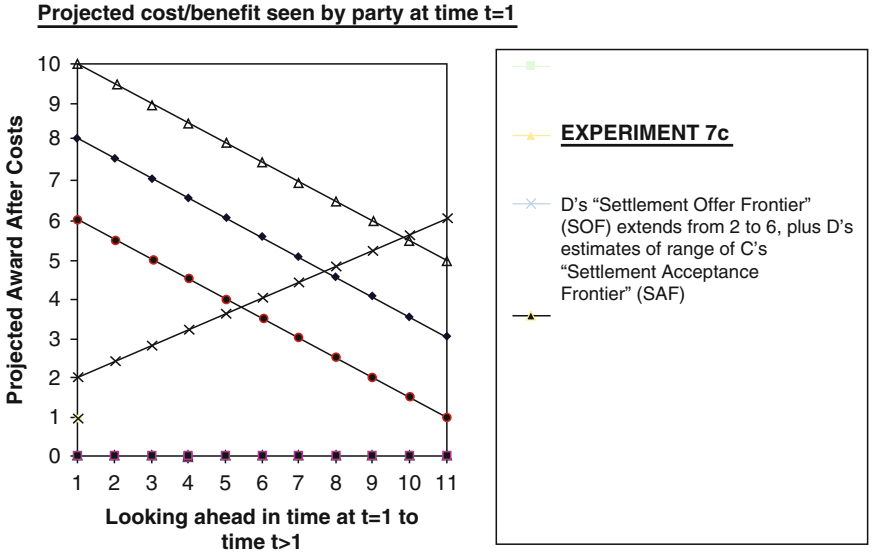
An obvious focal point X where C and D might settle is provided by the intersection of SAF and SOF curves. In diagram (7a) C in principle could accept any settlement value on or above the lowest point on SAF, i.e. any settlement on or above £3. Similarly, D could in principle accept any settlement on or below the highest point on SOF, i.e. on or below £6. Thus the feasible settlement set is £3–£6 which is generally and in this example different in size and range from the gap between the expected payoffs at trial as perceived by the two parties, here: £1.5–£9. Suppose that C and D know each other's trial expectations, risk premia and legal costs curves and can estimate Fig. (7a) accurately, then how can they agree a settlement amount between £3 and £6? The answer is that different rules and approaches will result in different values from this feasible set being agreed, if there is indeed agreement. However if both parties agree to settle on the figure that equates to their earliest settlement point and tells the other party that they only want to look ahead to $t = 8$ in this instance, then this arguably will allow the parties to coordinate on the focal point X where SAF = SOF.

In the absence of such perfect information about the other side, the best each side can do is to estimate both its own SAF or SOF and upper and lower bounds on the

SAF or SOF of the other side. Thus C might estimate that D's expectation of his payout at trial lay between £0 and £4 as shown in Fig. (7b) below, giving C a negotiating range of c. £5 2/3–c. £3 2/3, hence C's recommended opening settlement offer might be £5 2/3.



Applying the same strategy D might estimate C's expectation of his own payout at trial bounded between £6 and £10 as shown in Fig. (7c) below, i.e. between c. £3.75 and £5.5, thus D's recommended initial offer might be £3.75.



Thus in the imperfect information world while it is not possible to either enforce agreement at all or agreement at the intersection of the SAF and SOF curves, nevertheless it is possible for both sides to adopt a heuristic strategic approach to negotiation based on their own particular understandings of the SAF and SOF curves, that has a good chance of achieving settlement in this region. In the example illustrated this would mean C making a conservative initial offer of: c. £5 2/3 and D making a conservative initial counter-offer of c. £3.75. This start might enable the parties to converge on a settlement figure somewhere around the true intersection point X of: c. £4 2/3. For this reason, the intersection point X of SAF and SOF curves is considered as an implicit, attracting, "focal point" for settlement negotiations in the experiments considered below.

7.4.3 Effects of Lumpy Legal Costs and News Variability

In reality, legal costs are not just nonlinear over time but actually rather lumpy. This has the effect that the larger the time gap to the next legal costs and the smaller those projected legal costs, so the lower the opportunity costs and relative benefit to settling in the current period and the lower the likelihood for settlement negotiations and settlement occurring, particularly if they themselves are costly. Conversely the closer and larger the projected next legal costs, so the greater the incentive to negotiate and settle now. This implies that settlement is likely to be negotiated and actually to occur is very specific windows, e.g. before major trial or investigation costs are incurred and on the court steps, before a lengthy scheduled trial.

7.5 Mediation and Alternative Dispute Resolution

The question arises of how mediation, alternative dispute resolution fit into the framework above. Firstly the mediator/negotiator being perceived as more trustworthy by each side than the opponent, may be able to elicit better information about the expected payoff at trial and risk preferences of each counterparty. When transmitted to the other side this can allow the other side to gain a more accurate understanding of the location of the SAF and SOF curves, the location of intersection point X and hence improve understanding of the space for prior settlement. Secondly, any underlying "grudge factor" in direct negotiations will effectively reduce net risk premia and have the effect of moving the SAF and SOF apart, thus reducing the feasible set of settlement agreements. The mediator by stepping in can reverse this particular process. Thirdly by establishing better communications with each side, the mediator has more opportunity to identify tradable items on each side and to get each side to revalue each of these items in a way conducive to settlement. By revaluing and then swapping different tradable items on each side, the mediator

can reduce the costs of moving to settlement on both sides when seen from each side's own terms. Fourthly, the negotiator/mediator can focus the minds of participants on harsh realities, i.e. legal costs and the cost benefits of trial, once again bringing the SAF and SOF closer together by increasing perceived legal costs and perceived risk premia.

Finally where mediation is a discrete one-off process, if it fails then the opportunity is perceived as lost forever. This means that the "lost opportunity cost" of failed mediation is much higher to both sides than the lost opportunity cost of another particular missed settlement opportunity before trial, which can typically be repeated later up to trial. This in turn, if appreciated by both parties, and stressed by the mediator is appreciated as having extra value by both parties and hence gives both parties an incentive to move slightly closer toward settlement, which in turn increase the likelihood of successful settlement during mediation.

Thus mediation can be seen as a process which increases the chance of settlement before trial. It is typically an additional voluntary process before trial and will therefore be accepted unless one or other side perceives excess countervailing costs. These countervailing costs could be financial, but this is unlikely as the scale of mediation costs is usually much less than for other alternative legal costs. A more likely countervailing cost is the cost in terms of lost credibility and bargaining power, if it is feared that the mediator will give too much sensitive information to the other side or if one side fears that by accepting mediation, it is signalling lack of strength to fight the case in the alternative. A procedural rule that mediation is either expected or mandatory may therefore be beneficial as it allows both parties to accept mediation without thereby giving any signal of weakness.

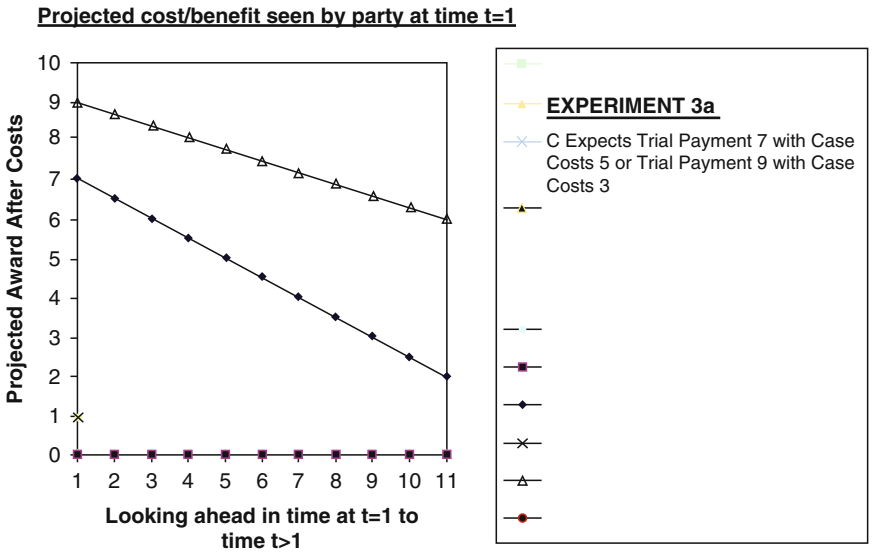
7.6 Lawyer Quality Cost/Benefit Trade-off

7.6.1 Cost/Benefit Scenarios

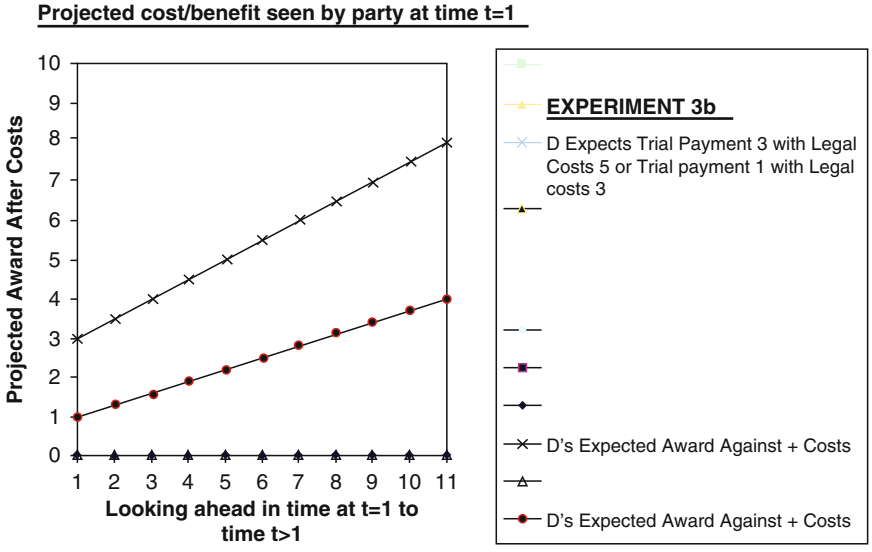
7.6.1.1 Case 1: Better Lawyer Also Cheaper

In reality the costs and quality of services offered by lawyer varies. For example, consider C's choice between two lawyers, one whom he expects to charge £3 for the whole case and to increase his payout at trial to £9 or another whom he expects to charge £5 and to achieve a payout at trial of £7. The better lawyer in terms of likely trial outcome is also the cheaper and C's SAF for the better lawyer lies everywhere above his SAF for the worse lawyer case. This is shown in Fig. (3a) below:

Therefore, C should clearly use the better lawyer if available in this example ceteris paribus. In a comparable example, suppose D has a choice between two lawyers one who he expects to charge £3 for the whole case and to reduce the payout at trial to £1 or another whom he expects to charge £5 and to achieve a



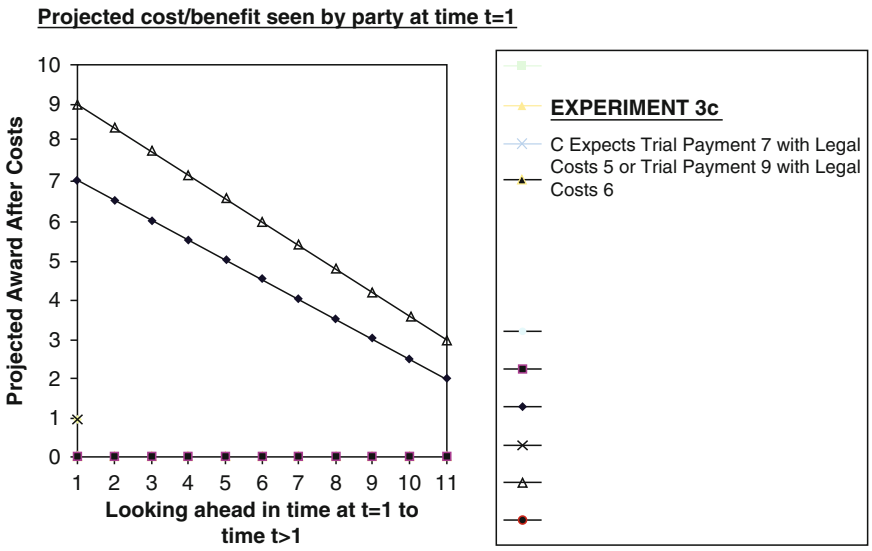
payout at trial of £3. Here the better lawyer in terms of likely trial outcome is also the cheaper and D's SOF for the better lawyer lies everywhere below D's SOF for the worst lawyer case. This is shown in Fig. (3b) below:



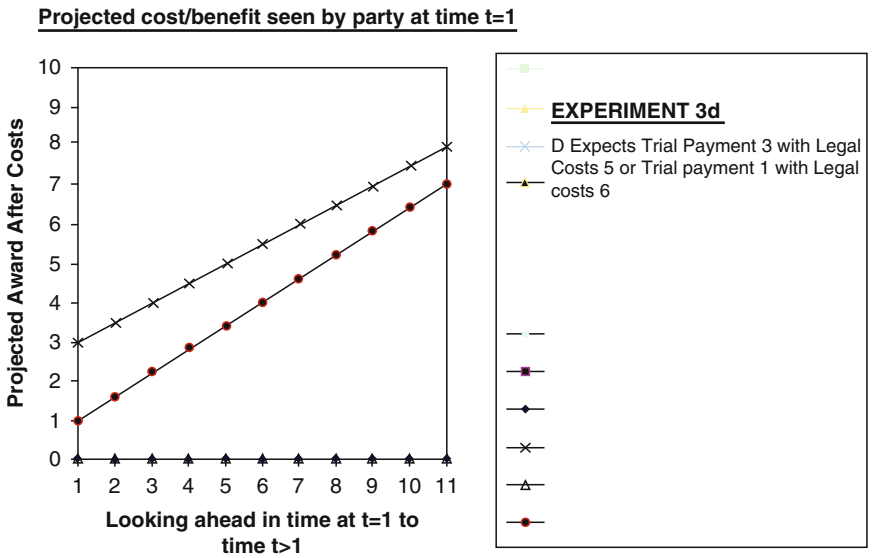
Therefore, by the same argument, it is worth D getting the better lawyer if available, ceteris paribus.

7.6.1.2 Case 2: Better Lawyer Marginally More Expensive

In the next scenario, the better lawyer considered by each counterparty in terms of expected payoff at trial is also marginally more expensive. However the better lawyer is still preferable as long his expected extra benefit in terms of trial payout is greater than his expected financial costs to trial. An example for party C is shown in Fig. (3c) below:



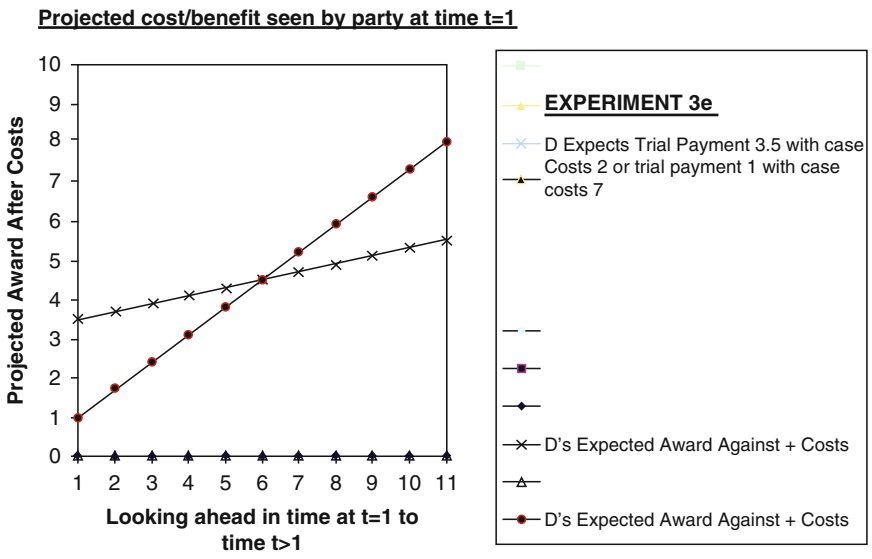
An equivalent case for party D is shown in Fig. (3d) below:



where the better lawyer is still preferable since his expected extra benefit in terms of trial payout is greater than his expected financial costs to trial. Thus the key condition is that from D's perspective the SOF of the better lawyer still lies everywhere below the SOF of the worse lawyer and from C's perspective the SAF of the better lawyer still lies everywhere above the SAF of the worse lawyer.

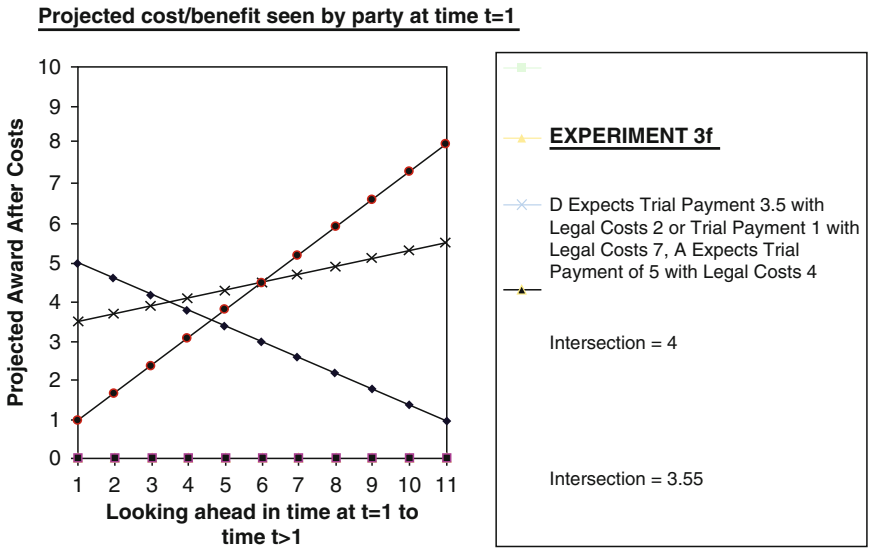
7.6.1.3 Case 3: Better Lawyer Significantly More Expensive

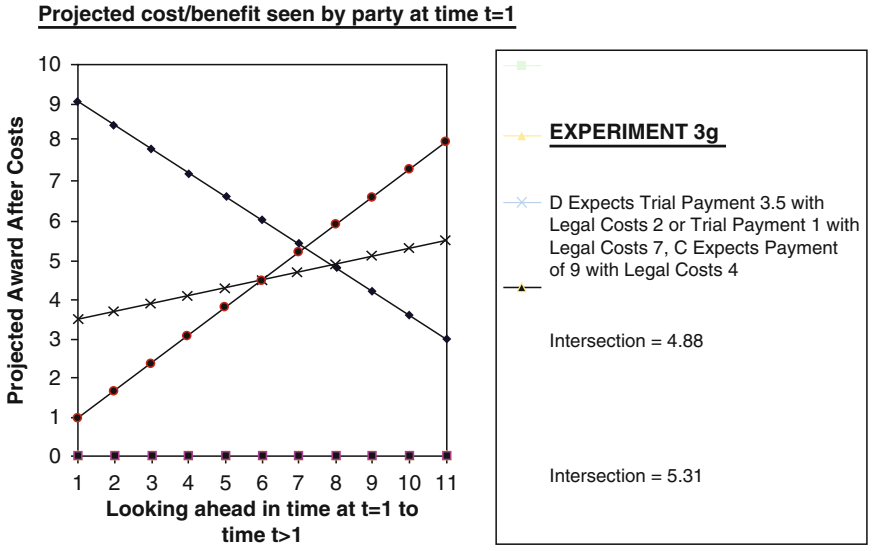
In perhaps a more usual case, the better lawyer considered by each counterparty in terms of expected payoff at trial is significantly more expensive. For example suppose D can choose between two lawyers one whose expected payout at trial is high at £3.5 but expected legal costs low at £2 and another lawyer whose expected payout at trial is low at £1 but expected legal costs to trial high at £7. This is shown in Fig. (3e) below:



D's optimal choice of lawyer will then depend on whether or not he anticipates forcing a settlement not just before trial but before or after time $t = 6$. If D expects to be able to force a settlement with C based on C's own cost expectations before time $t = 6$, then the lowest relevant SOF belongs to the better lawyer whom D should hire. This case is illustrated in example (3f) below:

By choosing the better lawyer in this case, D expects point X to fall from c. £4 to c. £3.55. Alternatively, if D estimates that he cannot force settlement with C before time $t = 6$, based on his estimate of C's projected costs before trial then the lowest relevant SOF for D will belong to the worse lawyer. This alternative case is illustrated in Fig. (3g):

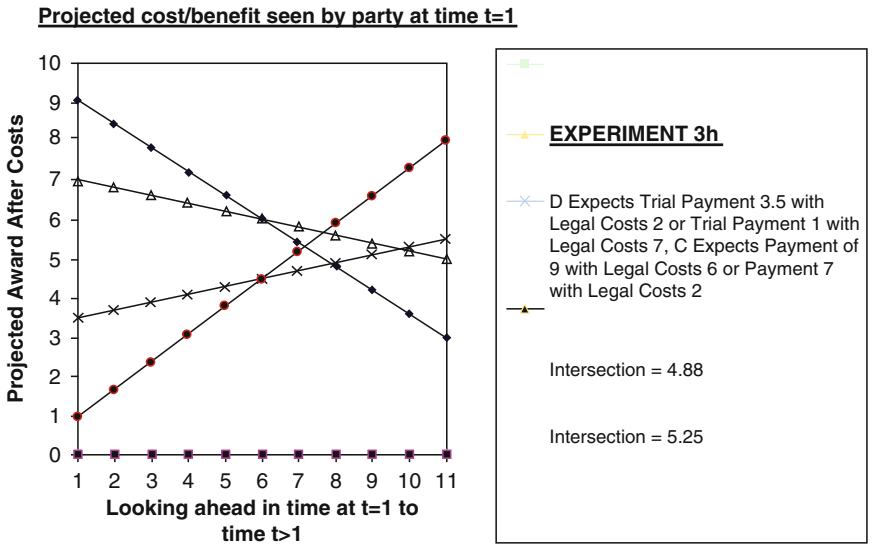




In this case by choosing the worse lawyer, D's expects point X to drop from c. £5.31–c. £4.88. It can be seen that D's optimal choice of lawyers in terms of cost and ability typically depends on C's SAF profile which in turn depends on C's optimal choice of lawyers in terms of cost and ability and visa versa.

In case (3h) either party starting with a better but more expensive lawyer can unilaterally move intersection point X and improve potential settlement in their

favour by moving to a worse but cheaper lawyer, with shallower SAF and SOF curves:



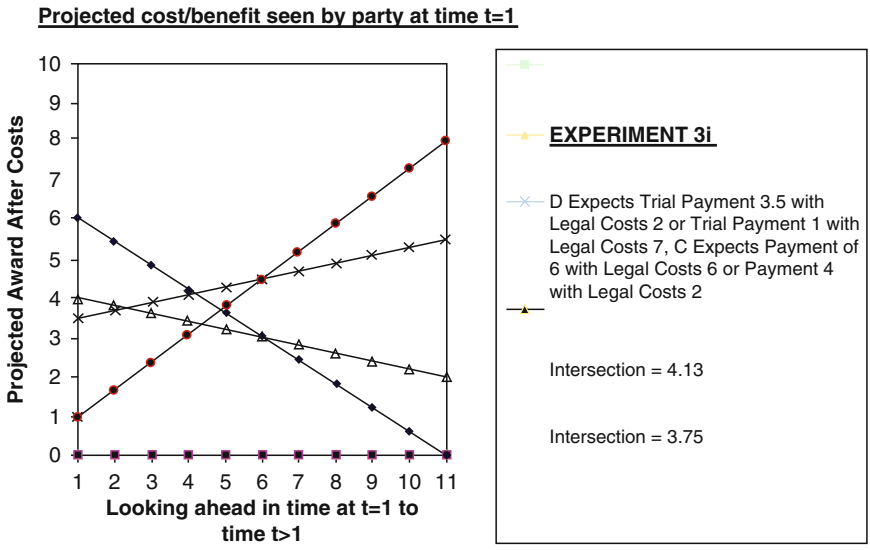
However the net result in this example is that much of the cost pressure from the more expensive lawyers to settle early is lost. Here both sides have to project ahead to $t = 10$, almost the end of the trial to perceive a benefit to settling. Moreover this settlement window will only last, in the absence of news and legal cost awards for one period until $t = 2$ and width of the feasible settlement set is small at c. £0.5. A similar example would be possible where both sides using cheaper lawyers, both lost any incentive to settle before trial. This illustrates a danger of inefficiently low legal costs, with diverse party expectations, namely inefficiently high litigation.

Similarly an alternative example where C and D both benefit from moving to a more expensive lawyer is shown in case (3i):

In this example, the greater marginal costs of using expensive lawyers is outweighed by the shorter projected time needed to look ahead to see the benefit of and to achieve settlement.

Thus the move by both sides to more expensive lawyers may increase or decrease intersection point X and may increase or decrease the time that both parties need to look ahead to see the value of settlement. However it will unequivocally increase the size of the feasible set of settlement values and in this sense increase the probability of settlement and variability of actual settlement figure that can be agreed, ceteris paribus.

(N.B. With these models it is also possible to get a number of changes as each side sees what other type of lawyer the other side is using it is also possible to get cycles between lawyer types, particularly in response to news about trial prospects and shifts in risk premia.)



7.6.2 *Lessons from Lawyer Cost/Benefit Trade-off Analysis*

Various lessons can be drawn from this simple lawyer cost–benefit tradeoff analysis:

22. Lawyers who are both cheaper and better are unequivocally preferable to each party choosing them to lawyers who are more expensive and worse, ceteris paribus.
23. N.B. This system weeds out bad expensive lawyers, encourages good cheap lawyers and helps to establish a positive relationship between lawyer quality and cost and demand across the lawyer cost range.
24. Lawyers who are unequivocally cheaper and better for one party are unequivocally worse for the other party, ceteris paribus.
25. Where there is a trade-off between lawyer cost and quality, the facts of the case, the opponents chosen cost curve and reactions may all determine whether a client should choose cheaper or more expensive lawyers or better worse lawyers and stick with them or change them.
26. As a client's information about the facts of the case and the opponent's choice, etc., change, and time to trial changes, so the client's choice of optimal lawyer may change, therefore it may become advantageous and it should be kept under review whether one should be using a more or less expensive lawyer.

7.6.3 *Principal-Agency Issues and Alignment of Client Legal Team Incentives*

Under the standard hourly-billing model, both solicitors and barristers have an incentive, ceteris paribus, to bill the maximum number of hours at the highest

hourly rate, ceteris paribus, up to their own sustainable working limits. This in turn means that they have no personal incentive to settle any case beyond any countervailing penalty costs incurred for not settling. They also have an incentive not to reveal the true expected costs of the case to new clients but rather to frame their fees in an opaque way. Both of these incentives are likely to be detrimental to the client as they cause him to make decisions based on inadequate and misleading information, decisions that are therefore likely to be worse than they could otherwise be and to cause the client to pursue a case he otherwise would not or to avoid settlement where he otherwise should.

7.6.4 Solicitors, Solicitor-Counsel, In-house Lawyers and Independent and Employed Barristers

One potential mechanism to protect the client is a Code of Conduct for each group of lawyers, with financial sanctions and associated reputational costs for transgression. However the required evidence to prove this may be hard or impossible to obtain. Another potential mechanism is reputation. The problem with this is that reputational damage is usually only incurred if a case is lost as opposed to if the case fails to settle at the right time and for the right amount. Any reputational damage from a lost case, that should have settled earlier, will depend on a number of factors. Often the lawyers have given general disclaimers then they may able to defend their reputations. Similarly the degree of reputational damage will depend on other factors, e.g. publicity and specialisation of the lawyer involved.

The last factor suggests that lawyers who specialise in a particular field and gain repeat business from informed clients will be much more subject and responsive to reputational pressure. This would apply to independent barristers (chosen by informed solicitors) and specific types of solicitor with the most repeat business and with informed clientele, e.g. independent commercial solicitors. By contrast, many other types of solicitor and internal solicitor's counsel would not have such strong reputational constraints. However a solicitor might still choose to use internal solicitor's counsel in preference to an independent barrister, as any extra profits derived by that solicitor counsel would now be shared via the same solicitor's firm with the case-solicitor himself. Thus there is a fundamental difference in terms of legal cost incentives and in turn likely legal costs between using external counsel and internal solicitor counsel provided through the same solicitor's firm. Consequently there is an argument that if solicitor counsel is used instead of a barrister, then he should nevertheless be independent of the case-solicitor's firm. An alternative way this may be achieved is by using an employed barrister in the case-solicitor's firm bound by a separate Code of Conduct and professional earning rules.

In another case, suppose D is a company using an internal company lawyer. Such a lawyer's perceived shadow cost of his litigation work may be zero and he may have a perverse incentive not only not to save costs for the company but even to

help to create costs by secretly generating more legal work for the company and hence more perceived demand for and payment for his own services.

Thus any given client has the daunting prospect of trying to align both the cost incentives of his own lawyers with himself but also of the opposing lawyer and the opposing client with himself. The relevant legal regulator has also historically had dual and conflicting duties and incentives to protect the client while simultaneously helping its own "union members" a fundamental conflict of interest recognised in the Clementi Report 2004. Recent attempts in England and Wales to address these conflicts of interest have involved partial separation of powers and imposition of "Chinese Walls", between the Bar Council, representing the interests of practicing barristers and its offshoot the Bar Standards Board here representing the interests of clients. Similar steps have been taken between the Law Society, representing the interests of solicitors and its offshoot the Solicitors Regulation Authority here representing clients.

Solicitor cost incentives could be aligned with the clients by instituting reforms such as the following: instituting a regulation that solicitors have to give regular written quotations predicting the expected cost profile over the whole case and upper and lower boundaries, information on external grading as to their quality in specific legal areas, explanation of their rule for allocating sections of work to different solicitors and external counsel at different fee rates and disclosure of those fee rates.

7.6.5 Lessons from Principal–Agent Issues

27. All lawyers who want to win the business, have an incentive to represent that they are better than they actually are at trial at the start of the case. This raises the perceived net present value of the potential case to the client.
28. Similarly, lawyers at the start of a potential case have an incentive to overplay the likely benefits of proceeding with a case.
29. All lawyers who want to win the business have an incentive to underplay the likely costs of any litigation. The one-off litigant without prior knowledge is particularly vulnerable to this. The way this can be done by the lawyer without lying or misrepresentation focusing the client's mind on cheap initial costs only as opposed to expected total case costs.
30. All lawyers have an incentive to generate the full costs of the case rather than settle, ceteris paribus.
31. To counteract this, a countervailing incentive is needed to align the settlement incentives of the solicitor with those of the client, e.g. a settlement bonus for the solicitor greater than the expected lost time costs of the lawyer finding a new equivalent client.
32. The corollary of this is that each side trying to settle must make sure that the settlement offer is properly transmitted to the opposing clients and not filtered out at the opposing lawyer stage.

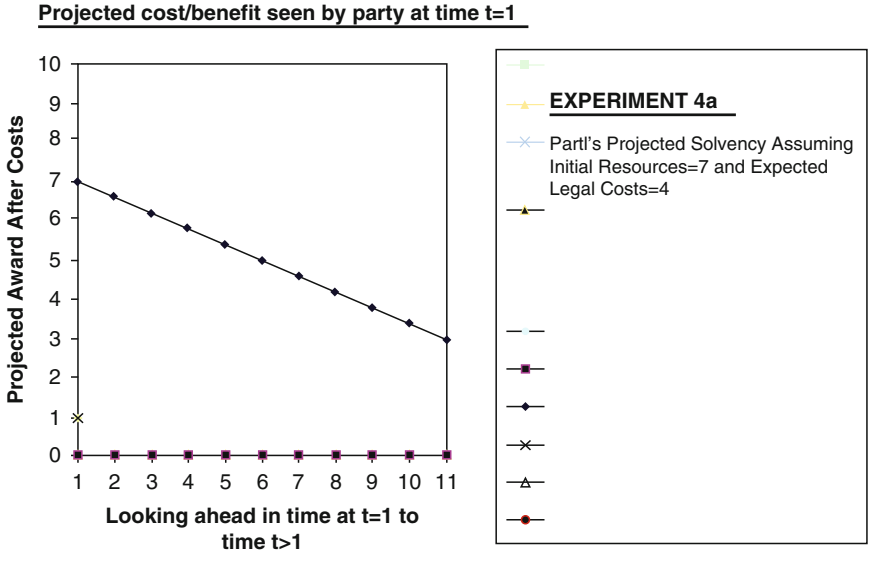
33. The cost incentives for a solicitor using in-house counsel is to maximise the cost of that counsel, ceteris paribus, because the case-solicitor has the same incentives to bill money via in-house counsel as via himself.
34. By contrast the cost incentive for a solicitor using external counsel is to minimise the cost of that external counsel, ceteris paribus. The solicitor also is able, as a highly informed viewer, to monitor the costs and output of external counsel.
35. For this reason external counsel used in a case is likely to provide much better value for money than internal counsel, ceteris paribus.
36. External counsel in a case is more likely to be under than overused, whereas internal counsel in a case is more likely to be overused than underused.
37. The incentive problem of using internal solicitor-counsel may potentially be solved by using an employed barrister instead, with different regulatory framework, remuneration and Code of Conduct.
38. Lawyers have an incentive, if they do not want a case, to overplay the likely costs and risks of the case and to underplay the likely return on the case.
39. This incentive is stronger for external barristers, who because of the "Cab-Rank Rule" may not alternatively be able formally to refuse to take a case they do not like. This strategy also benefits the barrister by providing additional insurance, should he nevertheless be given the case and fail to perform.
40. It may be advantageous for clients to get independent evaluation of the financial merits of a case from an independent solicitor and counsel who know that they will not thereafter be involved further in the case.
41. In-house lawyers dealing with litigation, may have a perverse incentive to maximise the amount of litigation directed to their firm and hence demand for their own services unless their own contracts are carefully designed to prevent this.
42. Similarly in-house lawyers dealing with litigation may have a perverse own-incentive not to settle before trial.
43. The client needs to keep in mind both the existence of and need to manage inevitable conflicts of interest within each of the two sides and legal teams.
44. The client needs to identify the relevant conflicts of interest on both sides and create a dynamic strategy to deal with them.
45. The client needs projected costs of the whole case under different alternative scenarios to be officially quoted by his solicitor on a periodic basis, particularly at beginning, middle and end of the case.
46. The client needs to share advice with his legal team to determine his own SAF or SOF and then to clearly transmit this information to the legal team.
47. The client also needs a mechanism to inform his legal team about any changes to his SAF or SOF and to take their advice on how it should be changed.
48. The client needs to neutralise the incentives of his legal team to settle at the wrong time and rate or to avoid appropriate settlement.
49. Thus in a standard hourly-billing model, the client may need to give an additional lump sum financial incentive for the solicitor to settle the case, covering the extra cost to the solicitor of waiting for a new client, plus a scaled

payment linked to the size of the settlement actually negotiated so that the deal is not struck at a disadvantageous level.

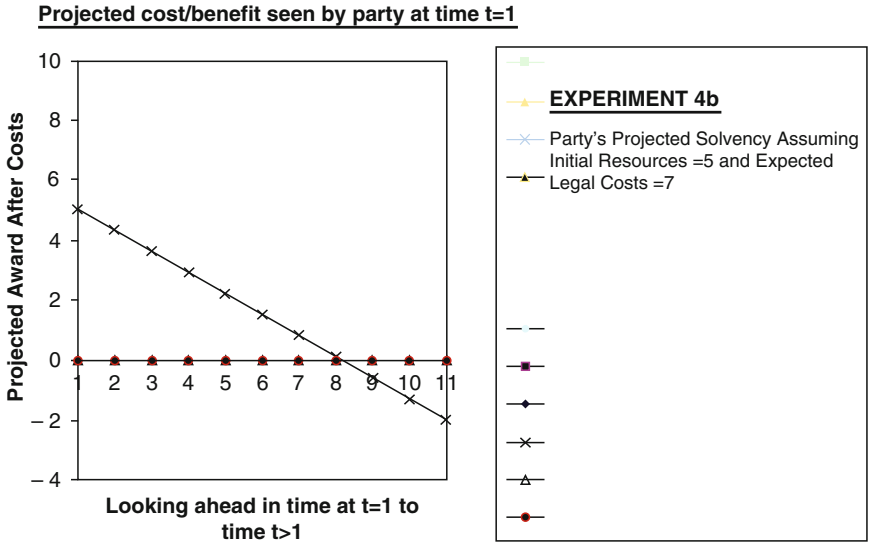
50. The client must also incentivise his solicitor to keep open negotiation lines with the opposition and also to ensure that any settlement offers are getting through to the opposing client and past that client's solicitor.
51. The client should be careful with regard to mediation ADR, balancing both the need not to give away too much information with the need to not miss a discrete opportunity for settlement. He might therefore choose to undertake mediation ADR but with the solicitor and not himself negotiating.
52. A regulator concerned about client costs and settlement should enforce a new rule about regularity, scope and clarity of advice by lawyers on the total expected costs of the case.
53. The new structures of the Bar Standards Board and Solicitors Regulatory Authority may focus on such measures.

7.7 Introducing Liquidity and Bankruptcy Constraints

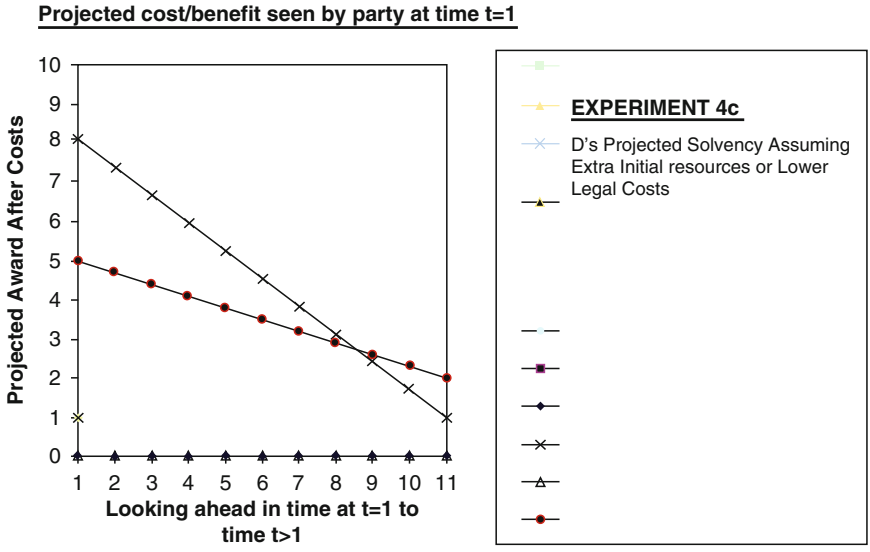
A key consideration in deciding whether to litigate, settle or drop an actual or potential case is availability of resources and associated liquidity or bankruptcy constraints. Suppose that one party starts off with total resources £7 and expects legal costs to be £4. That party therefore expects to remain solvent throughout the case and can bargain on the principle of knowing that he has the resources to go to trial. This issue is illustrated in example (4a) below:



Suppose however the party has initial resources of £5 and faces expected legal costs of £7 if the case runs to trial, as illustrated in diagram (4b):



In this case, the party now envisages that bankruptcy or illiquidity will prevent him from finishing his case after time $t = 8$ and actually reaching trial. Fig. (4c) shows two ways in which the party can avoid this. The first way is for him to obtain more initial resources, e.g. from £5–£8 and the second way is for the party to reduce his projected legal costs to a manageable amount, e.g. from £7–£3:



7.7.1 Conditional Fee Agreements

A third way is for the party to borrow resources to pay the legal costs, if the expected shortfall in liquidity is less than any expected payout at trial. This will particularly apply to a Claimant. A solicitor's "Conditional Fee Agreement" or CFA can be seen as a way of borrowing the legal fees, with the percentage premium comprising both a normal or excess profit margin for the solicitor and an insurance premium charged by the solicitors to cover any risk of non-payment. N.B The risk neutral insurance premium boost rate would be x% where the corresponding chance of non-payment was also x%.

One problem with CFAs is that the solicitor has an incentive to maximise the probability of payment being demanded from the client and this incentive can become perverse including setting implied conditions for solicitor payment when the client has not in fact received equivalent money at trial. Care therefore has to be taken by the client to ensure that the CFA is indeed watertight and that he only pays the solicitor when the client also gets paid by the court. Another problem with CFAs is that the terms have to be carefully set to be consistent with prior settlement whenever that would otherwise be optimal.

7.7.2 Lessons from First Review of CFAs

54. In a conditional fee "CFA" case, the client has to be careful to determine an incentive compatible rule determining the conditions for a settlement ending the case and the relevant level of fees then incurred.
55. The benchmark CFA rate boost should exactly compensate the solicitor for the probability of not being paid in the case, i.e. there should be an x% rate boost if the chance of case failure is x%
56. The insurance premium paid to borrow these funds could be either above or below a fair rate depending on the relative information and negotiating game and objectives of the client and solicitor.
57. In a CFA case, the solicitor has an incentive to maximise conditions of payment by the client, beyond conditions when the client himself wins at trial and also a perverse incentive not to draw this to the client's attention.
58. It would therefore be prudent for clients before signing CFA agreements with their solicitors nevertheless to get them first checked and reviewed or indeed written by another independent solicitor beforehand.

(For further discussion of CFAs, see Sect. 7.8.4 and onwards).

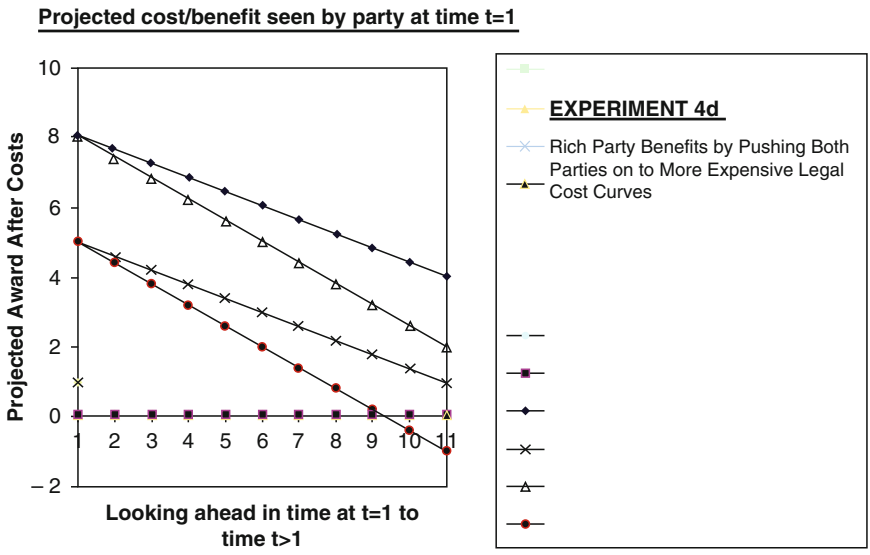
7.7.3 Bluffing re: Legal Cost Resources

A fourth way of dealing with liquidity and bankruptcy constraints, would be for the affected party to settle beforehand before incurring all the potentially bankrupting

legal costs. However this would only be possible if his opponent also had an incentive to settle, i.e. if the opponent believed that settlement was better for him than running on to trial. The opponent would therefore have to believe either that the first party had sufficient legal costs to fight the case or would not run out of costs before him. Therefore parties with inadequate legal costs to fight the case to trial have to hide this fact from the opponent in order to maintain their bargaining hand in order to achieve pre-trial settlement instead of trial or quitting with no settlement.

7.7.4 Legal Cost Battles

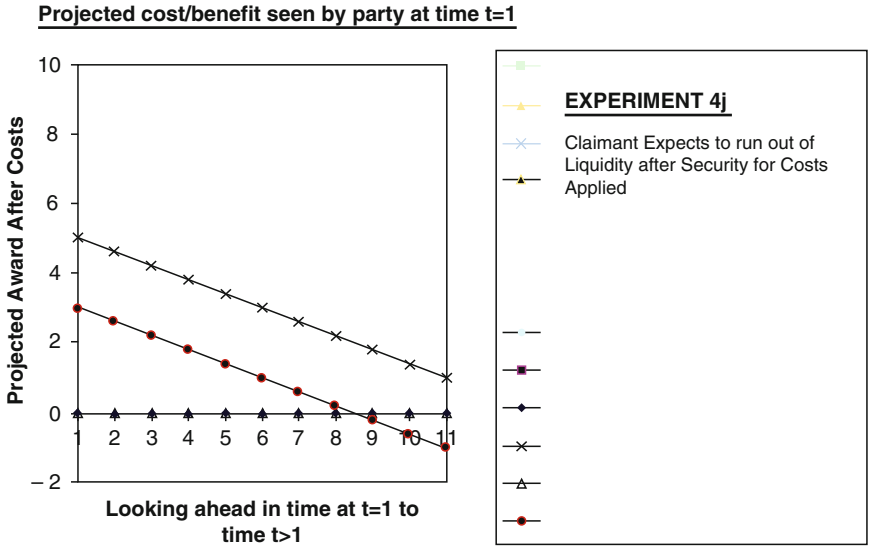
Conversely the ability of each party to call the other side's bluff, ignore settlement offers and wait for and help the opponent to drop out before trial, if the other side lacks adequate resources, gives both sides incentives to explore and possibly fight a legal cost battle. There are two direct methods of doing this. The first is to use up the opponents scarce legal cost resources. Thus the richer party may have an incentive to try to maximise the costs of litigation on the other side, e.g. by demanding excessive disclosure and hearings and also by generating extra costs on its own side when the Law of Costs applies (see section below). This is shown in Fig. (4d) below where the richer party benefits if he can force both counterparties on to their more expensive, i.e. steeper, expected legal fee curves:



Additionally if there is a significant time cost, then the richer opponent may have an incentive to show that it will drag out proceedings on both sides as far as possible as well.

7.7.5 *Collateral Orders: "Security for Costs" and "Freezing Orders"*

The second method is to disable those resources, e.g. by impounding them or creating a prior lien on them. Thus a Defendant facing a poor Claimant has an incentive not just to maximise projected legal fees on both sides as shown in Fig. (4d) but also to reduce the Claimant's available initial resources as much as possible. A direct method of doing this is for the Defendant to seek an order for "Security for Costs" against the Claimant under Part 25 of the Civil Procedure Rules. In this case, the Defendant argues that the Claimant must provide the court with collateral from which the Defendant's legal costs will be paid if the Defendant is successful at trial. Since the collateral has to be paid in to court immediately, i.e. before trial, this feature can itself reduce the Claimant's liquidity to the point where he expects to run out of resources before trial as shown in Fig. (4j) below:



The ostensible purpose of a "Security for Costs" order is to protect the Defendant from being forced to fight by a Claimant without a good case, who is subsequently unable to compensate the Defendant when the Claimant loses. Imposition of a "Security for Costs" order raises the expected costs of the case and thus reduces the expected net benefit, for the Claimant who expected or anticipated not paying legal costs if ordered to the other side after trial. Otherwise, the cost to the Claimant is marginal, increasing borrowing costs or lost investment costs. However, if there are capital market imperfections and the Claimant is unable to borrow the money, then a "Security for Costs" order can be used offensively by the Defendant to stop a Claimant, by exploiting the Claimant's illiquidity. Additionally, it may boost the risk aversion of the Claimant and signal the resolve of the Defendant.

A "Freezing Order" under Part 25 Civil Procedure Rules can be sought by a Claimant when the Defendant is believed to be able to hide its assets or move them offshore and thereby to escape paying out a judgement made by the domestic court. In such a case the Freezing Order granted, increases the expected payout by the Defendant at trial, if the Defendant expected to avoid paying out some of what it was ordered by the court by not paying out on these assets. It also reduces the liquidity of the Defendant before trial, reducing the available assets from which legal costs could be paid. Additionally, it may also damage his business and cashflow. N.B. The process of seeking and applying for "Security for Cost" and "Freezing Orders" also increases legal costs on each side and signals the resolution to fight of the applicants.

7.7.6 Lessons from Analysis of Illiquidity and Bankruptcy Constraints and Collateral Orders

The following lessons can be learnt from this discussion:

59. The prospect of illiquidity or bankruptcy during the litigation process or after trial needs to be carefully analysed by each party both from their own perspective and doing the same thought experiment for their opponent.
60. If one party knows that his opponent cannot or may not be able to afford to complete the case then he needs to act accordingly to exploit this.
61. Firstly he needs to signal to the opponent that he knows this.
62. Secondly he needs to press for and agree the most advantageous settlement in his own favour in such a case. For example if D knew that C would go bankrupt fighting the case then D could signal this with reasons then offer either zero or only nominal settlement. Similarly if C knew that D would go bankrupt fighting the case then he could offer to take as settlement the maximum amount that D could pay before bankruptcy.
63. A party facing bankruptcy could try to reduce legal costs to avoid bankruptcy or to raise additional funds to fight the case, e.g. via a CFA.
64. A party facing the prospect of illiquidity or bankruptcy later in the case should consider hiding this fact from his opponent and dissimulating his financial position on the one hand, while negotiating for settlement ostensibly on the basis of being able to win the case on the other.
65. Similarly a party should signal to his opponent and possibly also the court if and why he thought the opponent would go bankrupt or be unable to pay.
66. Paradoxically, this might mean that a poor litigant chose to use an expensive high quality lawyer initially to signal his solvency and determination and to force an early settlement despite not in actual fact being able to pay that lawyer' fees in full if the full case ran all the way to trial.
67. The poor Claimant should clearly be prepared to abandon a case rather than be bankrupted.

68. Optimal choice of lawyer would depend on the financial circumstances and also on the other party's choice of lawyer. It might also change for both parties during the case, e.g. with a rich lawyer followed by poor lawyers strategy, in the event that the case did not settle in time.
69. Claimants may be actively damaged by "Security for Costs" orders and Defendants by "Freezing Orders".
70. These apparent risk-reduction measures may thus be used offensively during the litigation process.

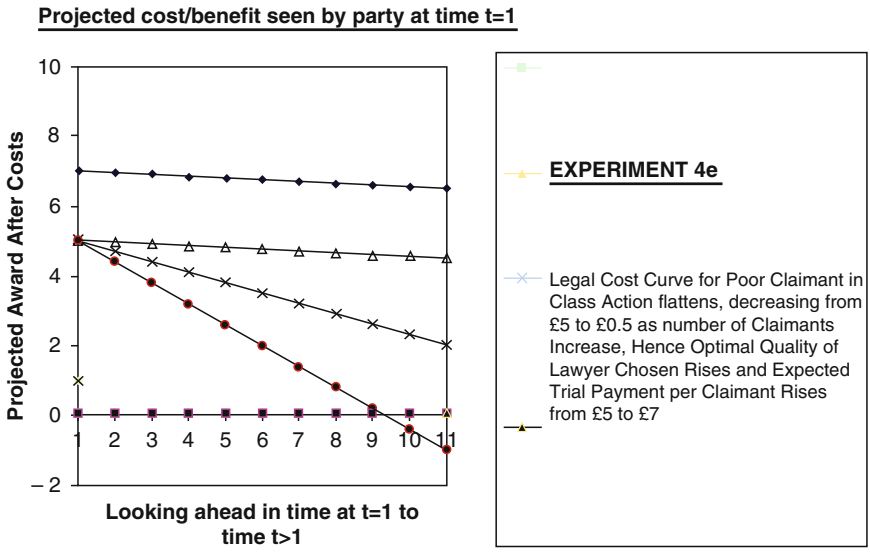
7.7.7 Signalling, Reputation and Class Actions

There is an additional benefit from vigorously fighting legal cost battles, for a large party who may be a serial Defendant in a potential sequence of cases. This is the signalling and deterrent, tough reputation effect. By gaining a reputation for generating or threatening heavy legal costs in initial cases and by this method, defeating or forcing the initial Claimants to give up, the Defendant not only saves net costs on the first case, but in all later cases. He does this, by deterring some or all of the subsequent potential Claimants. This means that the proportionate legal cost for the Defendant per potential Claimant can sometimes be minimised, by actually appearing to maximise costs fighting the first Claimant.

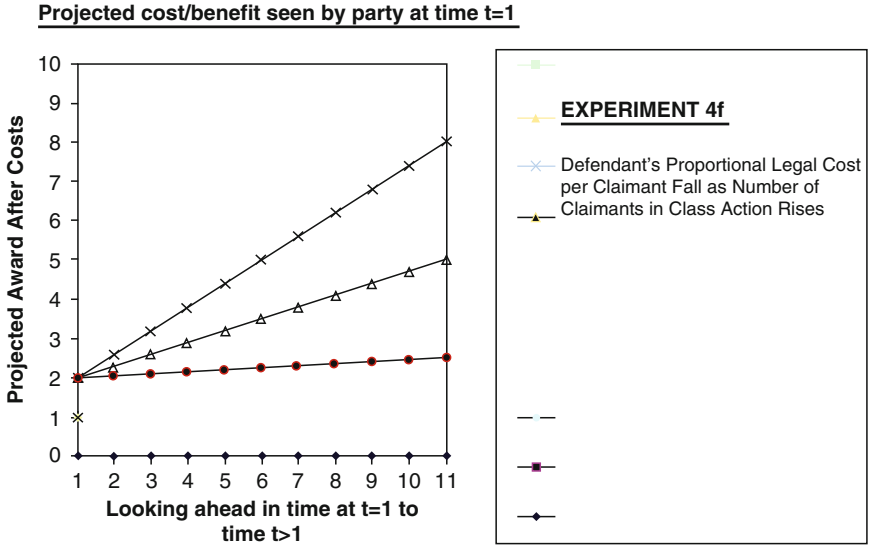
If this strategy is unsuccessful in deterring the first Claimants, then the Defendant has a similar incentive to minimise the payout at trial by maximising lawyer quality and associated legal trial costs. The reason for this is that initial trial awards will set precedents and benchmarks. The lower the initial benchmarks set, the more potential Claimants will see a negative cost–benefit and be deterred from litigation. Hence, the lower will be the Defendant's expected overall settlement payments and similarly the lower than originally expected, the payments to those Claimants who do pursue cases.

For this reason, wherever there are potential class action type situations with one large powerful Defendant and a large number of small potential Claimants, the Defendant will typically throw all its resources at defending the first case and early cases. The Claimants' typical counter-measure is to band together in a class action. Since the Claimants legal costs have an effective maximum value, proportional costs per Claimant fall towards zero as the number of class action Claimants bundled together rises. However the expected payoff per Claimant is typically positively related to their legal costs. Therefore the best approach in such a scenario is for a large proportion of Claimants to band together in a class action and then to maximise the quality of their own lawyers. This process is shown in Fig. (4e) by the flattening then rising SAF lines:

In this example a single Claimant, originally expects to obtain £5 at trial but to face legal costs of £6 to get there. The single Claimant can see that he will run out of money before time $t = 10$, i.e. before trial. He therefore cannot succeed at trial or indeed even get an out of court settlement if the Defendant knows about the



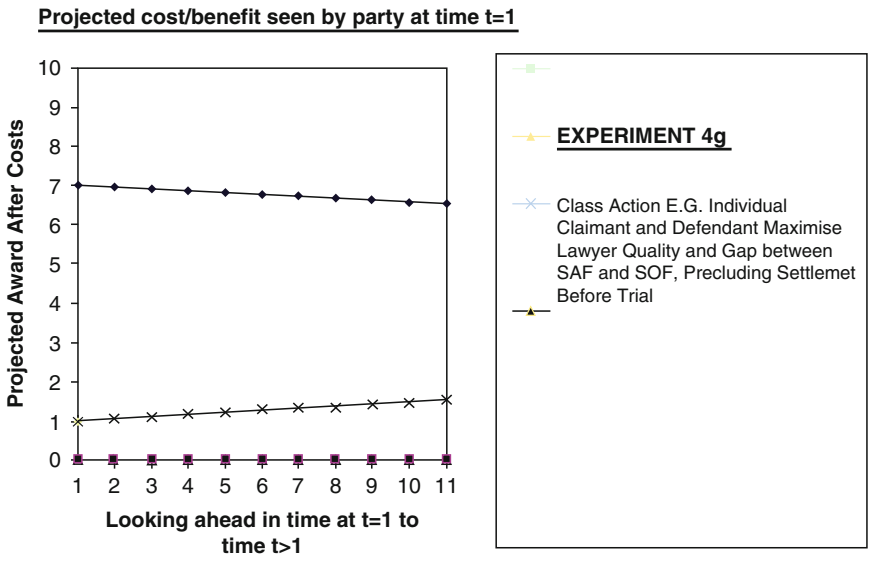
Claimant's financial position. However, as additional Claimants band together in a class action with the original single Claimant, then the expected legal costs per Claimant fall approximately proportionately. This means that the expected legal costs per individual Claimant in the class action, fall from £6–£0.5 in the example and the SAF flattens, as shown above. Each Claimant is now able to pursue his case to trial, something that the Defendant also knows. Moreover as the legal costs per Claimant fall to zero as the number of Claimants in the class action rises, so the



costs per Claimant of increasing lawyer quality also falls to zero. However the potential benefits in terms of expected payoff per Claimant at trial from better lawyers is unaffected by the number of Claimants, ceteris paribus. In Fig. (4e) this is shown as increasing from £5–£7.

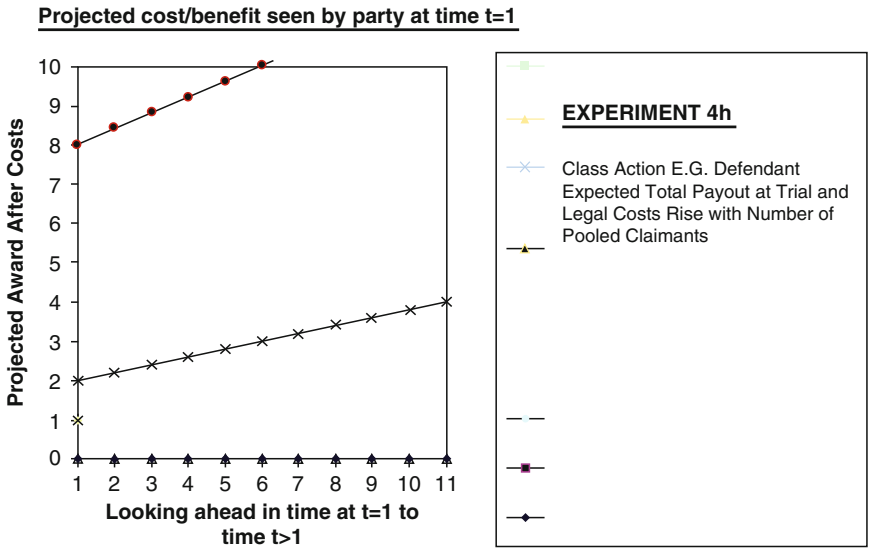
The Defendant can analyse this situation in two contradictory ways. Looking at each Claimant individually, the expected legal cost per Claimant falls as the number of Claimants in the class action rises as shown in Fig. (4f):

In this example the Defendant initially expects to pay £2 to an individual Claimant at trial with legal costs of £6 to get to trial, with legal costs per Claimant falling to £0.5 as the number of Claimants rises. This would suggest that the Defendant also has an incentive to maximise lawyer quality, thus reducing the expected payout per Claimant at trial. Fig. (4g) shows that when such Defendant and multi-Claimant strategies are combined then there is little chance of the SAF and SOF intersecting before trial hence one might expect such cases always to proceed to a hard fought trial.

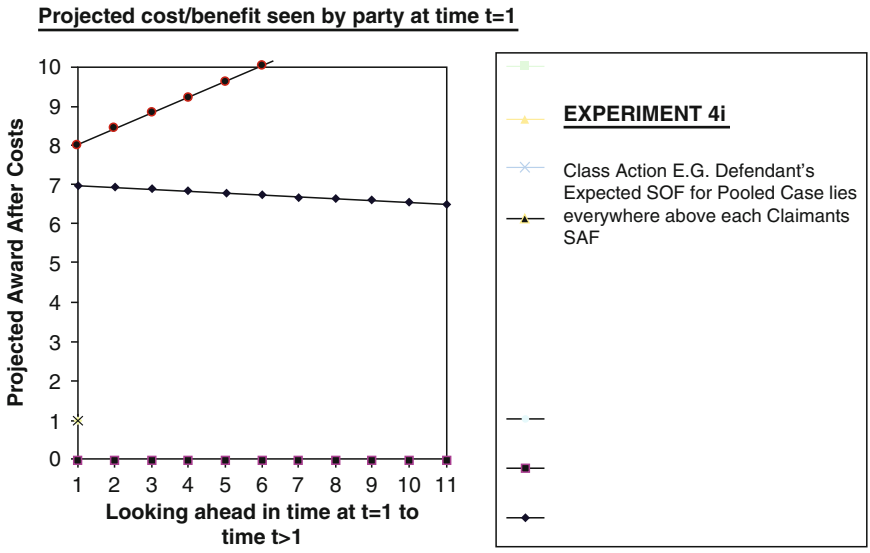


7.7.8 Confidential Settlements and Non-admission of Liability

However, if the Defendant looks at all the individual Claimants in a class action together and considers his incentives per overall case as opposed to per individual Claimant then, as the number of Claimants rises so does the Defendant's total expected case payout and this effect will swamp any expected saving from better quality lawyers. This is shown in Fig. (4h) below:



Here the Defendant's SOF for one Claimant includes expected trial payout of £2 and expected legal costs of £2 and the Defendant's SOF for five Claimants includes total expected trial payout of £8, being 1.6 per Claimant and total legal costs of 4. In this case putting the Defendant's SOF for the combined Claimants together and the SAF for each individual Claimant gives the result shown in Fig. (4i) below:



In other words for class actions, the Defendant has a much stronger incentive to settle before trial when he looks at all the Claimant's pooled together. This gives the Defendant an additional incentive to stop a class action developing and to stop all

the other potential Claimants from learning about and sharing in any potential settlement that they would also either have to be paid or which would also motivate them to enforce similar payments at trial.

The way the Defendant can stop a class action developing is first to take a very tough deterrent stance with individual litigants to hopefully deter them and secondly to spot any class action that seems to be starting and nip it in the bud with a settlement that is both confidential and does not admit liability. N.B. Non-admission of liability is important given the possibility of news leaking out or subsequent action. If, despite this, a full class action does develop, then the Defendant has an incentive to throw all legal resources into the defence. Clearly in a world of risk, imperfect information and imperfect communication, all three phenomena are possible, namely: the individual Claimant from a class deterred, the confidential private settlement for a few members of the class and the full class-action litigation battle.

When there are a small number of Claimants and no larger class of potential Claimants then there is an intermediate situation. In as much as the joining of Claimants means that their resources are increased, so the likelihood of these Claimants running out of money before trial falls and hence the prospect for the Defendant of either having to settle or fight the case rises. However, the Defendant does not have the settlement incentive to secretly buy off the current Claimants, coming from potential savings from future potential Claimants who could otherwise join the class action. The Defendant could even have a contrary incentive to gain an enhanced reputation for toughness from fighting the current case. This means that where there is a small band of Claimants and none in reserve then a case of type (4g) is more likely to pertain. This suggests that cases of a small group of Claimants against a larger Defendant are most likely not to settle and most likely to go to trial unless the current Claimants can either threaten to create a larger class action or move the Defendant's expected payout at trial close to their own expected payoff at trial.

N.B. If the Defendant is known by the Claimants to have limited resources, then as the number of Claimants rises, so the average payout by the Defendant to each successful Claimant may fall. This gives both Claimants and Defendants additional incentives for confidential no-liability settlements where current Claimants and the Defendant effectively combine forces to share out the Defendants resources between them, to the detriment of other ignorant, potential future Claimants.

7.7.9 Lessons from the Analysis of Signalling, Reputation and Class Action

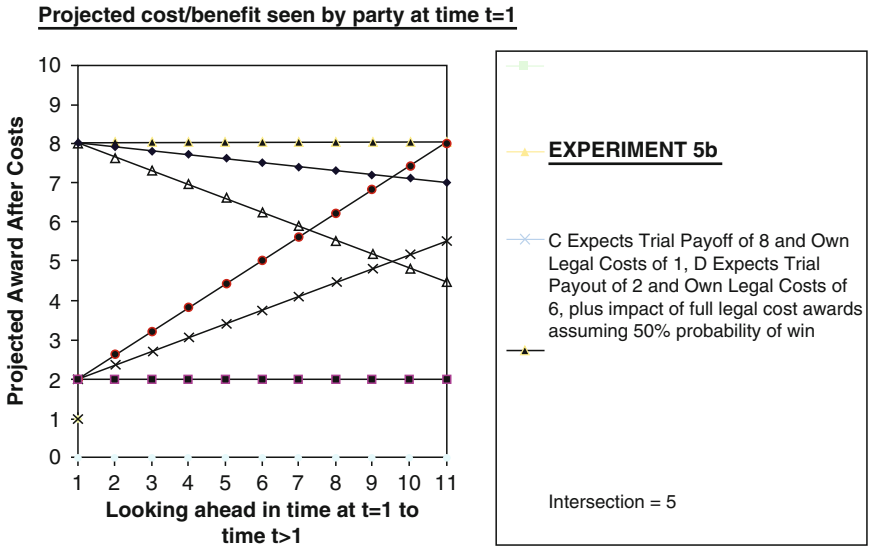
71. Both parties need to identify quickly if there is current or future class action potential to the case.

72. The Claimant has an incentive to join a small group of Claimants, if this significantly reduces his case costs and the threat he faces of illiquidity or bankruptcy before trial.
73. Otherwise the Claimant has to balance up the strengthening of his team by the addition of extra Claimants with the greater difficulty this creates for the Defendant in agreeing to a pre-trial settlement and any reduced availability of assets available per Claimant if the Defendant also has limited resources.
74. The Claimant needs to maximise any credible threat to create a class action before actually doing so.
75. The Defendant's optimal response to a credible threat of ensuing class action may be to try to buy off the current Claimants to keep them quiet and to prevent them becoming a focal point for a class action and also to prevent the information about their settlement reaching other members of the potential class action class.
76. The Defendant's best method of doing this is via a confidential no-liability settlement with the first Claimants, combined with tough public posturing.
77. It is in interests of the Defendant for the settlement to be without admission of liability as the admission of liability is itself potentially costly, e.g. if it becomes publicised.
78. The Claimant also benefits from the non-admission of liability, as this both makes the settlement feasible and increases the funds effectively available for the settlement.
79. In such a case the potential maximum settlement amount achievable by the current Claimants is very high, being the potential saving for the Defendant from avoiding both the current trial and subsequent class actions.
80. In such a case the non-disclosure aspect would be vital to the value of the settlement deal to the Defendant and hence the Claimant should use this as a bargaining chip.
81. A Defendant is likely to identify a single poor Claimant as such and then use whatever offensive cost tactics are available so that the Claimant envisages not being able to afford the prospective case and gives up immediately and costlessly for the Defendant.
82. A single Claimant therefore needs to convince the Defendant that he has the resources and willingness to fight the case.
83. In a potential class action case, the individual Claimants have an incentive from the nondisclosure agreement in their settlement not to disclose this to their peers and thus not to help the other potential ignorant Claimants.
84. The non-disclosure element can also be used by the Defendant against the Claimants individually, so that individual Claimants in the group may not know accurately what other members are receiving This in turn can increase the variability of settlements for the individual Claimants, thus benefiting the individual winners and reduce the overall settlement amount thus benefiting the Defendant.

7.8 Impact of "Law of Costs"

In certain jurisdictions, e.g. England and Wales, the "Law of Costs" implies that the "costs follow the event", i.e. that the loser in a case is ordered at trial to pay some or all of the other side's legal costs. A key feature is that there is considerable equitable discretion to the judge in this area and variability about the exact cost award. There is also usually some wastage, i.e. the expectation that not all costs requested will be ordered. This feature needs to be factored into the legal cost benefit analysis of both parties as it will affect both the expected legal costs of both parties and the expected variability of those costs and hence associated risk premia. Consider an initial case below, without LOC, where both sides will pay their own costs. C expects payoff at trial of £8 and own legal costs of £1. D expects trial payout of £2 and own legal costs of £6. The low legal costs of C and high legal costs of D mean that the SAF and SOF curves intersect close to what C would expect to receive at trial namely £7.25.

However when LOC applies then the adjusted expected cost profiles of each party are adjusted as shown below:



This example uses the benchmark assumption that each side envisages a 50% chance of eventually paying both their own and the other side's costs and a 50% chance of paying no legal costs. (N.B. This particular assumption is just for ease of exposition and can be relaxed without loss of generality). It can be seen that adding LOC has the effect of equalising the expected legal costs on both sides in this case and reducing D's expected full legal costs from £6–£3.5 and increasing C's expected full legal costs from £1–£3.5. This in turn reduces the SAF: SOF

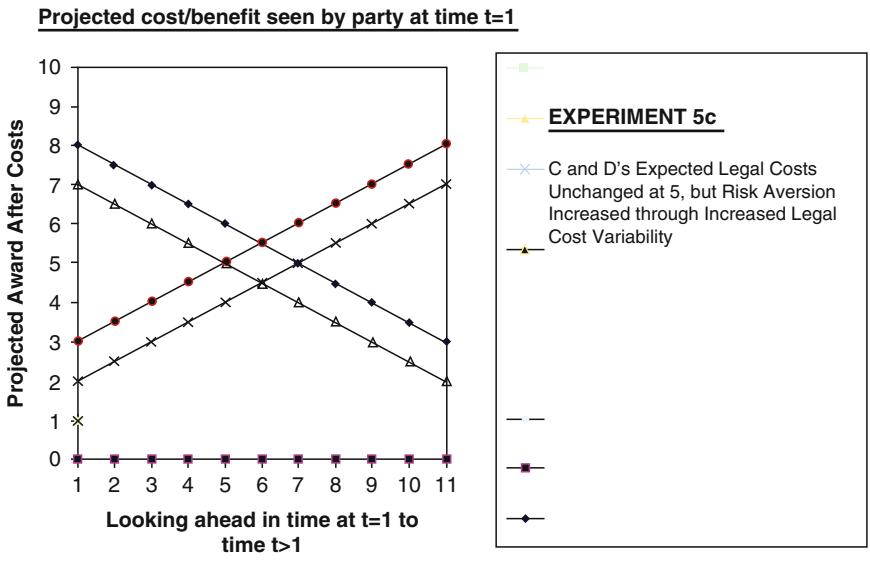
intersection point from c. £7.17–£5 in the figure above. This implies that the effect of LOC in this example is to move prior feasible settlements in favour of the higher own legal cost generating party.

The possibility of eventually paying the other side's costs or of having one's own legal costs paid has two effects. Firstly it changes the overall expected total legal and case costs and cost incentives for each party. Secondly it changes the expected variability of those legal costs and hence the risk premia applied to both SOF and SAF as explored below:

7.8.1 Effects of LOC and Expected Legal Costs

7.8.1.1 Case 1: Own Expected Legal Costs Unchanged by LOC

In the first case, each side considers that their own expected legal costs are unchanged by LOC. Both sides however must therefore believe that their cost variability has increased and hence their risk premia to avoid this will also have increased, assuming that they are risk averse. This has the effect of moving both SOF and SAF closer together as shown below in Fig. (5c):

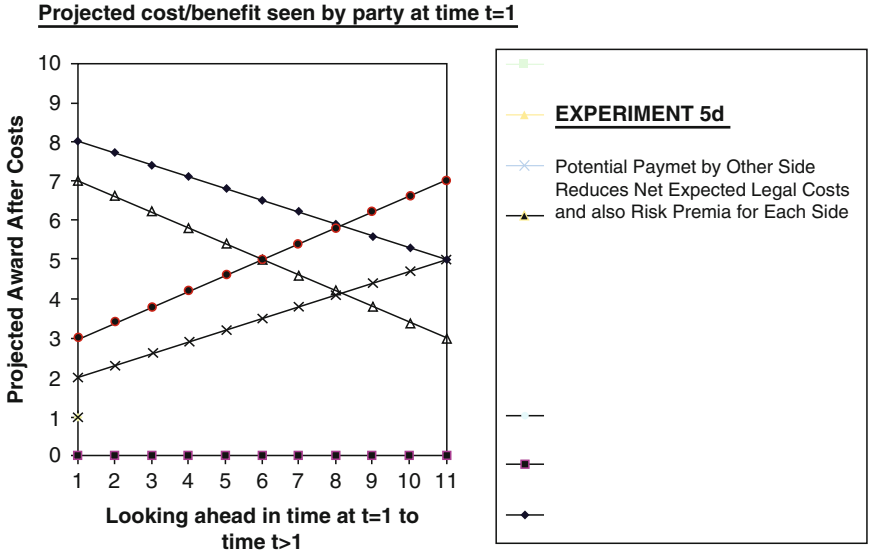


In this case, the expected payoff at trial after risk premia, decreases for C from £8–£7 and the expected payout by D after risk premia, increases from £2 to £3. Hence the intersection of SAF and SOF remains at £5, but both parties now only have to think ahead to time $t = 5$ instead of $t = 7$ to see the benefits of settlement. Similarly the feasible settlement area has increased from £3–£7 instead to £2–£8.

Hence increasing the risk to each participant through LOC in this example just increases the likelihood of settlement before trial without altering the focal point £5 of that settlement. In other examples X might rise or fall with the addition of LOC. It would also be possible to have a similar case where the SAF and SOF curves did not intersect without LOC but did intersect with LOC. In such cases the application of LOC would both make settlement before trial advantageous and also save the dead weight loss of any alternative legal bills.

7.8.1.2 Case 2: Own Expected Legal Costs for Both Sides Reduced by LOC

However it is also possible for LOC to encourage both sides to litigate, if the subjective expectations on both sides are that each will win his case. In such examples, LOC can reduce the subjective expected legal costs for both sides, thus reducing the steepness of their own perceived legal cost curves. It is also likely in such cases to reduce the perceived variability of own legal costs and thereby to reduce the risk premia applied to the SAF and SOF curves, thereby widening them further. An example of this is shown in Fig. (5d):



In this case, C initially assumed a payout at trial adjusted for risk premia of £7 and expected legal costs to get to trial of £4 without LOC and an expected payout at trial adjusted for risk of £8 and expected net legal costs to get to trial of £3 with LOC. Similarly D initially assumed payout at trial adjusted for risk of £3 and legal costs of £4 without LOC and assumed payout at trial adjusted for risk of £2 and net legal costs of £3 with LOC. In this case the focal point settlement value of £5 is unchanged by LOC, but the parties now have to think further ahead from t = 6–11

to achieve it. Additionally the size of the feasible agreement set has shrunk from £3 to £7 to a point at £5. It is easy to imagine similar cases where the SAF: SOF intersection point X will have risen or fallen and also where adding LOC will have caused SAF and SOF no longer to intersect and so preclude feasible settlement before trial.

7.8.1.3 Case 3: Own Expected Legal Costs for Both Sides Increased by LOC

This is the reverse of case 2 above and a stronger version of case 1, with SAF and SOF curves moving together with LOC both because of increased risk premia and risk aversion and because of perceived increased costs of trial on both sides.

7.8.1.4 Case 4: One Side's Expected Legal Costs Increased, One Side's Decreased by LOC

This is the case illustrated by example (5b) above. In this case point X will always move in favour of the higher own legal cost generating party, although the break-even time corresponding to X could be either sooner or later with LOC than without LOC.

7.8.2 "Sunk Costs" and "Reclaimable Costs"

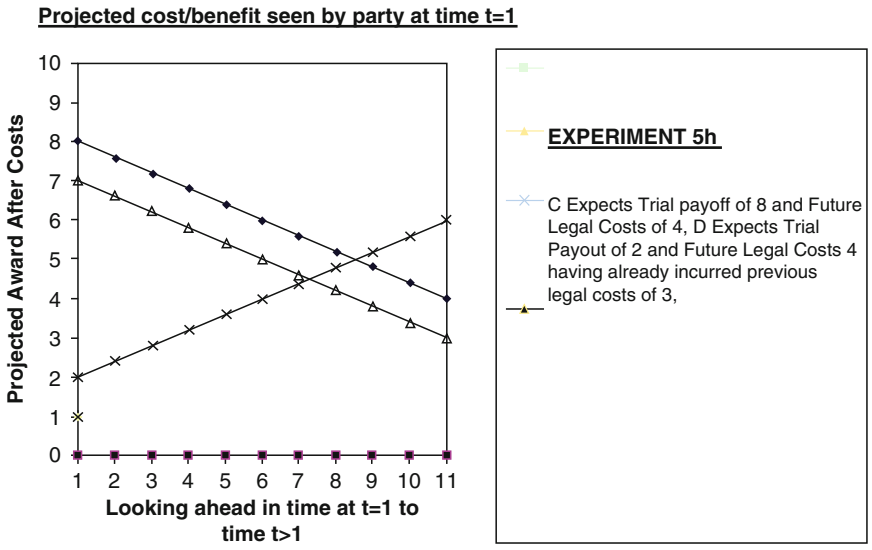
Without LOC, legal fees already spent will only have an indirect effect on any potential settlement via: risk premia, expected payoffs at trial, liquidity and expected future legal costs. As own legal costs are paid out in this situation, they effectively become "sunk costs", permanently paid or owed by the commissioning party.

However with LOC, the party who has paid the legal costs can still subsequently win some or all of them back, if he wins at trial. Conversely, the second party if he loses at trial can still additionally lose the first party's historical costs at trial as well. Therefore with LOC, costs already incurred cease to be "sunk costs" and instead become potentially "reclaimable costs".

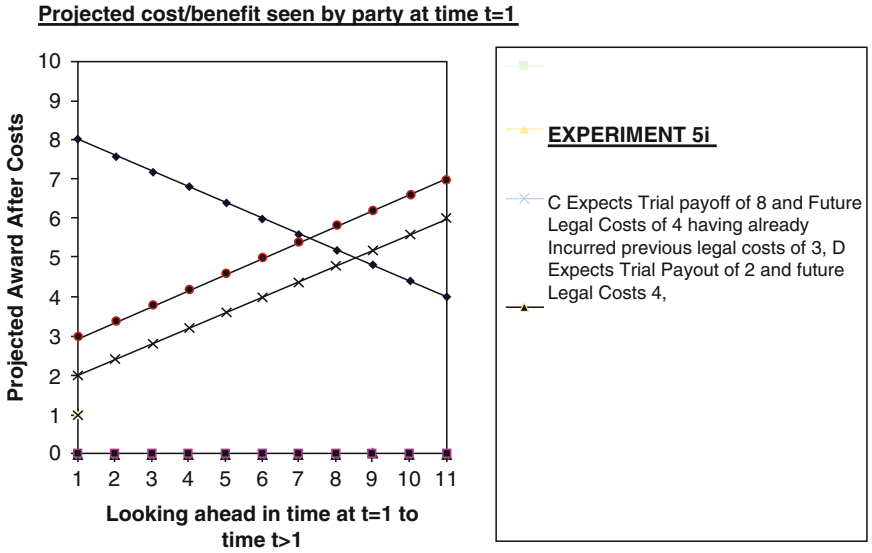
With LOC, the net cost to a party of losing at trial increases with the previous costs on both sides. Thus each party has an incentive to add extra prospective costs on his own side, to increase the probability of his not losing at trial by enough to cover all those additional previous costs. This feature tends to increase the legal costs paid by each side in subsequent periods, ceteris paribus. Thus LOC gives both parties an extra incentive not to lose at trial and to chase: both their own and the other party's previous costs.

The impact of previous costs on potential pre-trial settlement can be illustrated as follows. In example (5h) the assumption is that at $t = 1$, C has incurred no legal

costs, whereas D has already spent legal costs of £3. C sees a certain probability of paying some or all of the £3 back to D, if C loses at trial. Hence the impact of D's prior expenditure is to reduce C's own expected net payout at trial from £8 to £7 and to lower his SAF curve as shown in Fig. (5h) below:



Similarly in example (5i) the assumption is that at $t = 1$, D has incurred no legal costs, whereas C has already spent legal costs of £3. D sees a certain probability of paying some or all of the £3 back to C, if D loses at trial. Hence the impact of C's



prior expenditure is to increase D's net expected payout at trial from £2 to £3 and to move D's SOF curve upwards as shown below:

Thus the impact of LOC is for previous costs on both sides to move the SAF and SOF curves closer together. This may increase or decrease the intersection point X depending on the slope of the curves and on which side has spent proportionately more to date. Ceteris paribus, the greater one side's prior legal spending, the more a settlement in that party's favour is likely to improve with the addition of LOC, although if both SAF and SOF are sloped, then the increase in benefit from settlement will be less than the increase in prior legal costs. Hence the parties do not have an incentive to generate unbounded early legal costs.

LOC will also reduce the time that both parties have to look ahead to see the benefit of settlement, since some of the costs they factor in to this analysis have already been incurred at time $t = 1$, i.e. carrying over from the past. This factor will also increase the size of the feasible settlement set.

One additional feature is that the more legal costs have previously been incurred on both sides, so the greater the marginal benefit to extra legal spending now on one's own side. This factor alone means that adding LOC will add a tendency for costs to increase exponentially over time on each side, ceteris paribus. This feature additionally increases the size of the prior feasible settlement set. It also gives an incentive for each side to increase its margin law costs both in terms of both active number and quality of lawyers progressively over the course of a case from case inception with say a single assistant solicitor on to court trial with say barrister Q.C and full backup team.

The optimal amount either party should spend at any point before trial will also depend, with LOC, on the total prior spending of both parties. Thus as the opponent spends more, so the legal cost danger to client increases and he should spend more to defend himself against this risk, ceteris paribus. Additionally, a party may choose to incur extra legal costs early in a case to signal and prove to the opponent that it is able and prepared to incur those costs, particularly since the opportunity cost of such expenditure falls if these are no longer sunk but now potentially reclaimable costs.

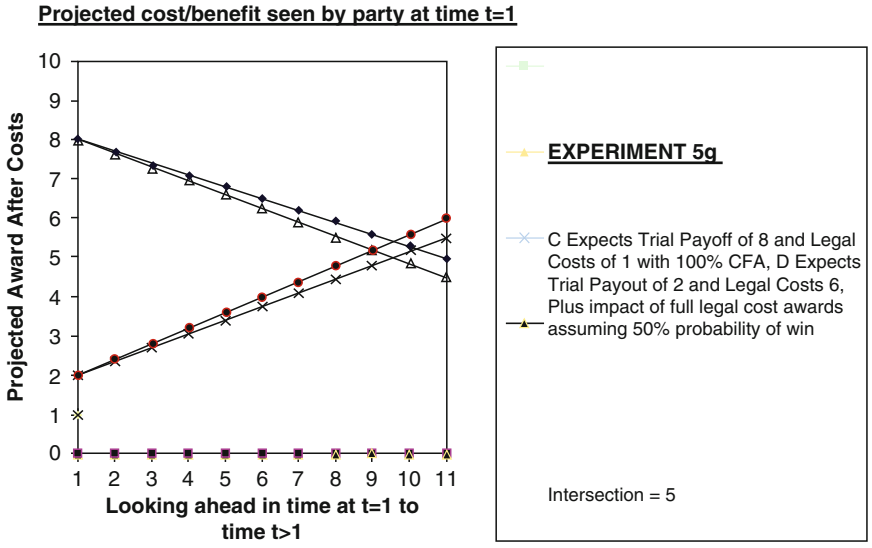
7.8.3 Lessons from Analysis of LOC

85. LOC can change the expected payouts at trial, risk premia and expected legal costs on both sides.
86. Typically, if C and D are evenly matched then adding LOC will increase risk premia on both sides, closing the gap between SAF and SOF and increasing the scope for settlement.
87. However, if both sides are confident or over-confident, then the addition of LOC will decrease perceived risk premia on both sides, increasing the gap between SAF and SOF and decreasing the scope for settlement.

88. The impact of LOC is typically to skew a feasible settlement towards the party who can threaten to generate the higher future legal costs and who has generated the higher previous legal costs.
89. Thus LOC is more beneficial to parties who have a natural power and wealth advantage, e.g. large Defendants.
90. An impact of LOC is that previously incurred legal costs are no longer fully sunk costs, but are reclaimable at trial and therefore have an impact on future settlement.
91. LOC is likely to cause settlement to move in favour of the party with the higher previously generated legal costs, but by a smaller factor. This removes an incentive for parties to generate unbounded legal costs early in the case.
92. Assuming that potential costs orders under LOC are subject to a proportionality test, then parties never have an incentive to generate unbounded legal costs in UK courts.
93. However the more legal costs have already been generated in the past, so the greater the marginal benefit, ceteris paribus to additional legal costs today on each side.
94. Thus LOC should raise all marginal legal costs and add an element of exponentially increasing legal costs over time to the case and also increase the likelihood of settlement before trial.
95. Adding LOC may increase or decrease point X, the intersection of SAF or SOF curves, but in most cases is likely to decrease the time that both parties need to look ahead to see benefits from settlement and also to increase the range of feasible settlement values.
96. With LOC, the client's optimal marginal legal cost expenditure rises with all the past costs of the case generated by both the client and opponent.
97. LOC thus favours progressively increasing lawyer quality and marginal costs for both client and opponent as the case progresses to trial.
98. Addition of LOC will change the optimal lawyer tradeoff in favour of better, more expensive lawyers, ceteris paribus.
99. However if the losing party is unable to pay the winner's fees, then this effectively neutralises the effect of LOC for the winner.
100. Under LOC each party needs to determine whether the opponent will be able to pay his own legal fees or is likely or intends to default. This feature can radically change the optimal legal expenditure and strategy of the non-defaulter.
101. Under LOC, parties need to use "Security for Costs" orders, "Freezing Orders" and any other available steps to get collateral for their own legal fees.
102. The prospect of the opponent losing and not paying legal fees in the case, could change his optimal choice of lawyers and optimal legal costs and indeed the decision by the non-defaulter on whether to fight the case or not.

7.8.4 CFA Premia Revisited and LOC

The premia attached to a CFA also affect trial payouts and settlement negotiations in the same way as differential legal costs award. Consider example (5g) below, being (5b) adjusted so that Cs legal costs are now covered by a CFA with 100% premium. Thus C expects to receive a payout of £8 at trial and D expects to pay out £2 at trial. D's expected own legal costs to trial are £6. If D pays C's legal costs without a CFA then this increases to £7 and when C has a CFA to £8 overall. Assuming a 50% chance of paying the other side's costs plus his own and a 50% chance of paying zero legal costs, Ds expected legal costs to trial are £3.5 if C has no CFA and £4 if C has a CFA.

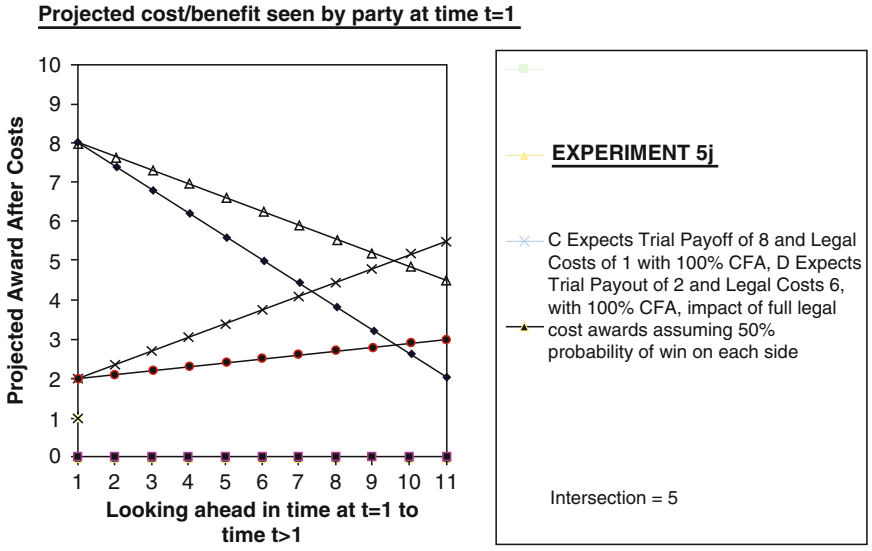


Similarly, without a CFA C's expected legal costs are 50% of (£6 + £1), i.e. £3.5 and with a CFA C's expected legal costs are 50% of £6, i.e. £3. Thus a CFA reduces expected legal costs for the CFA party and increases expected legal costs for the non CFA party, given LOC. In example (5g) the addition of a CFA increases point X in Cs favour from £5–c. £5.5 and moves the set of feasible settlement agreements from £4.5–£5.5 instead to £5–£6. N.B. CFAs can only work if their premia are paid by the other side, i.e. given LOC.

7.8.5 CFA Beneficial and Perverse Incentives

By flattening a party's own SOF or SAF curve and steepening the other party's curve, a CFA both improves the expected pre-trial settlement for the CFA party,

since that party is now more likely to go to trial and the other party less likely to go to trial, ceteris paribus. This implies, paradoxically, that the best defence for a Defendant facing a Claimant using a CFA may be for the Defendant to use a countervailing CFA himself, to increase the expected cost pressure on the Claimant and neutralise the expected cost reduction effect of the Claimant's own CFA. This is illustrated in Fig. (5j) below being (5g) but where D has also added a 100% CFA:



In this example when both sides have 100% CFAs and 50% expected probability of winning, C's expected legal costs to trial are 50% × £12, i.e. now increased to £6 and D's expected trial costs are 50% × £2, i.e. now reduced to £1. Because of the implied tax effect of the CFA premium on the opponent, both expected if the opponent loses and overall, therefore it is in both parties' interests to have CFAs. However the greater beneficiary in terms of expected own legal cost reduction and increased expected cost pressure on the opponent is the higher own legal cost generating and premium generating party.

In example (5a) without LOC and therefore without CFAs, point X, the SAF: SOF intersection was at £7.25, close to the own expected payout at trial to the low cost generating party C. With LOC added in, in example (5b) assuming a 50% chance of each side winning on costs, point X fell dramatically to £5, i.e. in favour of the higher legal cost generating party D. The addition of a CFA by C in example (5g) reduced the expected legal costs faced by C and increased the legal costs faced by D, thus moving X to c. £5.5. However the subsequent addition of a CFA by D in example (5j) more than reversed this process moving X to c. £2.86 in favour of D, the high own legal cost generating party.

Another paradoxical result is that it is in the interests of both the CFA party and his lawyer for the CFA premium to be as high as possible. This is akin to the Klemperer 2000 result, where instead of maximising own legal costs to maximise chance of winning at trial in a legal fee auction, the CFA premium is maximised instead to maximise the cost to the other side of fighting and losing and hence maximise the cost to the other side of not settling beforehand and hence to ensure such settlement. Solicitors could potentially exploit this fact both by offering CFAs with high premia and telling the clients correctly that it was actually in the clients own best interests for the premia to be this high, ceteris paribus.

The net effect of CFAs depends on whether one or both parties are able to use them. If there is no constraint, then it is likely to be optimal for both parties to use CFAs which will then favour the party with the highest own legal cost generation and percentage premia. By boosting the net expected costs of the other side, CFAs may enable each party additionally to increase the threat to the other side of being bankrupted by the case, exploiting its bankruptcy and liquidity constraints, see above. This in turn my prevent litigation progressing and increase the range of feasible settlement offers.

The next question is whether parties are able effectively to insure themselves against possible loss awards including the other side's CFA premia, if they lose the case. If they could, then the insurance premia would increase in line with: the other party's costs, CFA premia and probability of success at trial as perceived by the insurer. Thus the losing case premia would increase in line with the expected costs of losing in the absence of insurance. However by reducing the variability of outcome for the party, paying insurance against losing costs would be likely to enable risk averse parties close to their bankruptcy thresholds to continue to litigate.

Thus CFAs can theoretically be used particularly by Defendants, to deter liquidity constrained Claimants, particularly in the absence of insurance for losing party legal expenses when the other party has a CFA. The impact of such insurance would be both to increase the size of CFAs and to increase the number of litigants progressing towards trial.

Were CFAs only to be available to Claimants then this would have two effects: firstly it would make cases with little intrinsic prospect of success viable and hence result in inefficient use of court time and increased ability of marginal Claimants with CFAs to threaten Defendants. Secondly the use of a CFA as a remedy for a capital markets failure, i.e. the inability of a worthy but liquidity-constrained Claimant to fund their case would have been remedied at the cost of a new market failure, i.e. the encouragement of low merit cases and the taxation via prior settlement of intimidated Defendants, with the tax collected and retained by the relevant solicitors.

On the other hand, applying a proportionality test, judges might use their equitable discretion not to authorise the payment of CFA premia that were unreasonable, leaving this component of the bill either unpaid or payable by the CFA client. These two features would be likely to put effective limits on the size of CFA premia. It should be noted that there would also be a perverse incentive for the solicitor to leave the client liable for any CFA premia agreed but not ordered to be

paid by the loser and for the solicitor not to draw this remaining risk to his client's attention. The client–solicitor contract terms relating to the CFA would therefore need to be carefully drafted, ideally by an independent third party solicitor to protect the client from this risk, which would closely match the risk that the client had tried to avoid via the CFA itself, but now occurred if the client won as opposed to lost at trial.

Another key issue is whether the CFA premia are paid in the event of prior settlement. If they are paid then this gives the actual party involved an extra incentive to go to trial as this would be his only way of recouping the CFA premia directly from the opponent to pay his solicitor. If they are not paid then it gives the solicitor an extra incentive to avoid pre-trial settlement as this causes him to lose his CFA premia. It is therefore likely that optimal CFAs would need to charge somewhat lower premia in the event of pre-trial settlement plus settlement bonus balancing out these two factors. Interestingly, the use of CFAs would also favour use of third party solicitors rather than in-house lawyers as it would not be plausible for a company to have a CFA with itself.

There are thus clearly strong public policy issues connected with the use and potential abuse of CFAs. For solicitors they are potentially a highly profitable enterprise and therefore one would expect them to be regularly offered. If the CFA premia are meant to reflect risk then there perhaps there needs to be a maximum allowable limit. However even this will be high, e.g. a factor of 10 and there would also be problems distinguishing between cases with no merits and cases with potential merits but say initial lack of disclosed evidence. One way to control the growth of CFA premia would be to add a rule so that they would always financially impact the client using them, e.g. so that only 80% of the premium would be claimable under a cost award.

7.8.6 LOC, Liquidity and Bankruptcy Constraints and Implicit CFAs

With LOC, a high spending winner at trial can retrieve his costs, but not if the loser at trial becomes bankrupt or otherwise unable to pay. This risk for a high spending party who expects to win at trial can be mitigated if that party is the Defendant and obtains a full prior order for "Security for Costs", see above, or obtains some other good collateral. Otherwise, his legal cost risk remains exposed. Therefore if one side is a potential defaulter (PD), then the other non-defaulting party (ND) needs to factor this in to his case and determine whether to fight the case and how much correspondingly to spend on lawyers. Effectively, with LOC, the ND effectively writes a partial free CFA for PD. The ND expects to be disproportionately penalised in such cases as he will either pay his own costs if he wins or his own plus PD's costs if he loses as in Fig. (5g) above. Moreover in this case ND cannot increase his cost pressure on PD via his own CFA if PD has no intention and ability to pay legal

costs anyway. Similarly ND's solicitor is unlikely to enter into a CFA with ND unless PD's potential legal payments are also guaranteed by ND, which in turn is likely to be self defeating for ND.

One possibility is that if PD had his own CFA then he would not have paid out resources to his own solicitor during the case leaving more resources potentially available to the ND. Therefore it would be in the interests of both the ND and the PD's solicitor for the PD to have a CFA. This suggests that ND should raise this issue of potential non payment of legal fees with the PD's solicitor, either to encourage the PD's solicitor to withdraw from the case or to impose a CFA, thereby freeing funds from PD to pay the opposing side in the event of losing the case. Indeed it is likely that PD's solicitor would only take the case if protected by his own CFA.

Alternatively, the ND should reduce his own legal expenditure to the point where any further expected marginal reduction in legal fees was exactly offset by an expected marginal reduction in the expected payout from the case including legal fees actually paid. This could mean ND abandoning a case or settling at a less advantageous rate than he would if the opponent were not a legal cost default risk.

7.8.7 Lessons from Analysis of CFAs

103. A CFA decreases expected legal costs for the CFA party and increases expected legal costs for the other party, ceteris paribus.
104. The CFA premium creates an implied legal costs tax and threat to the other party.
105. A CFA may increase or decrease the time both parties need to look ahead to see benefits of settlement.
106. A CFA should unequivocally increase the equilibrium settlement amount in favour of the CFA party.
107. Thus both parties have an incentive to have CFAs.
108. An optimal response, whether or not one party has a CFA may be for the other party to have a CFA. Thus it is likely to be equilibrium, if there are no other constraints for both Claimants and Defendants to use CFAs.
109. Since the benefits of CFAs are not available to a party using an in-house lawyer this gives an incentive to such a counterparty to use an external solicitor plus CFA rather than internal lawyer and no CFA.
110. The implied legal tax cost to one party from the other party's CFA and CFA premium, is collected by and paid to the other party' solicitor, who drafted the CFA, in the absence of defaults.
111. The solicitor drafting the CFA thus has an incentive to maximise the CFA premium.
112. The client receiving the CFA, who benefits from the implied tax effect on his opponent, also has an incentive to maximise the CFA premium as long as he does not pay it himself and as long as it does not preclude settlement.

113. The solicitor drafting the CFA agreement has a perverse incentive not to warn the client that the client may face a risk in the event of success and the CFA premium not being paid by the opponent.
114. The solicitor drafting the CFA agreement has a perverse incentive if the CFA premium is not paid for prior settlement, to avoid prior settlement.
115. The solicitor drafting the CFA agreement has a perverse incentive if the CFA premium is paid for prior settlement, not to highlight this to the client as this might otherwise deter the client who might become liable for this premium from such settlement.
116. Thus an optimal CFA agreement is likely to have a different lower premium payable for prior settlement and possibly an additional settlement bonus for the solicitor.
117. Because of the perverse incentives a CFA agreement should be drafted and/or checked by a fully independent third party solicitor.
118. If CFAs are only available to Claimants then they may replace the market failure of good but illiquid Claimants being unable to come to trial, with new market failures of inefficient wealth transfer from Defendants to solicitors, excessive litigation and intimidation of Defendants, i.e. excessive use of settlement instead of trial or non-litigation.
119. If CFAs are available to both Claimants and Defendants then they are likely to be optimally used by both. This is likely to increase the chances of settlement and move expected settlement in favour of the higher own legal cost generating party ceteris paribus.
120. Judicial and regulatory rules can be used to control CFAs, e.g. provisos that CFAs are only allowed in certain circumstances and that only a fixed proportion of the premium is payable by the loser and that excess premia can be struck out.
121. It is likely to be optimal for a party with a CFA to signal or indicate this to the other party, for use in cost based negotiations.

7.9 Optimal "Part 36 Offers"

Under Civil Procedure Rules (CPR) Part 36, both parties to civil litigation under the law of England and Wales can and are encouraged to make Part 36 Offers to the other side during civil litigation. Part 36 Offers are private during the trial but revealed and impact legal cost awards after trial. The rule is that: if the receiver of the Part 36 Offer retrospectively after trial would have been better off accepting that offer instead of proceeding to trial, then he is subsequently punished on costs. The purpose from the court's perspective is to give parties extra benefits to making and accepting pre-trial settlement offers and hence, ceteris paribus, to ensure that more offers are made and more disputes settled before trial. The use of Part 36 Offers can thus be optimised by each side to reduce the own side's expected legal costs and increase the opponents expected legal costs.

Since both Claimant and Defendant can make such Part 36 Offers, since either can subsequently win the case and since the offer made can be higher or lower than the court award at trial, thus there are eight possible alternatives when a Part 36 Offer is made as set out in Table 7.1.

Table 6a) B distinct Part 36 Offer Scenarios

Scenario	Offeror of Pt 36 Offer	Subsequent Winner at Trial	Offer Better than Trial Payout	Extra Trial Payout on PT 36 Offer	Benefit to Offeror of Part 36 Offer	Beneficiary	Scaled by Whose costs:
1	C	C	Y	Yes, D pays extra Idemnity cost premium on all C's costs after Offer Date	Moderate	C	C
2	C	C	N	No	Zero	C	
3	C	D	Y	Yes, D loses all costs from C incurred after Offer Date	Large	C	D
4	C	D	N	No	Zero	C	
5	D	C	Y	Yes, C loses all costs from D incurred after Offer Date	Large	D	C
6	D	C	N	No	Zero	D	
7	D	D	Y	Yes, C pays extra indemnity cost premium on all D's costs after Offer Date	Moderate	D	D
8	D	D	N	No	Zero	D	

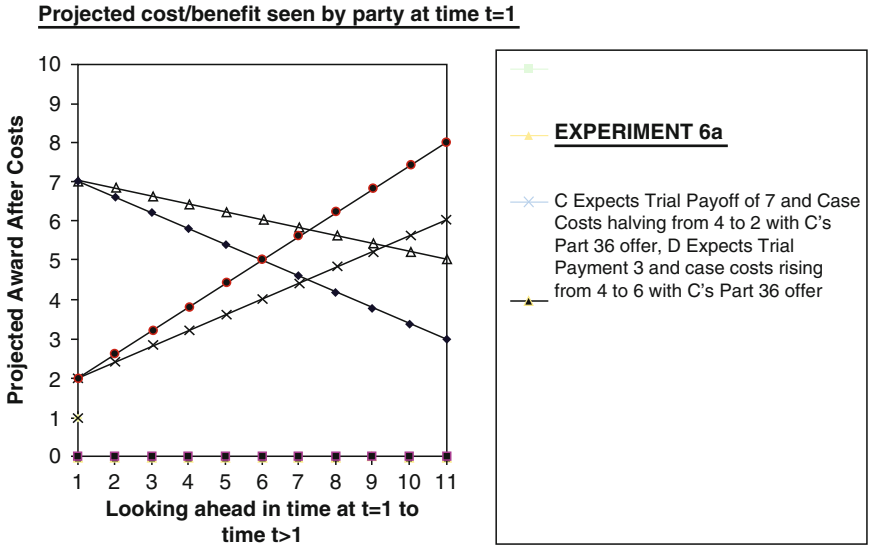
In circumstances where the offeror wins, then he would have received his costs from the loser in any event. If the Part 36 Offer would have been better to the loser and hence if the loser should have accepted this and thus avoided trial, then the loser's punishment is to pay the opponents costs at a boosted indemnity rate after the offer date. This provides a moderate boost to the offeror, for making the offer. In particular the presumption is that costs that might have been disproportionate are now paid by the loser and interest on the costs and the judgement amount can be paid at up to 10% above base rate. Thus if the case concerned a historic debt repayment or a situation where the current base rate was much lower than 10% as now, then this indemnity cost basis boost could become proportionately very significant.

In cases where the offeror loses, but his Part 36 Offer was still bigger than what the winner was awarded at trial, then the winner actually should have accepted the Part 36 Offer earlier and avoided trial. To punish him for not doing so, he loses the costs he would naturally have been awarded from the loser from the date of the Part 36 Offer. This provides a potentially large boost for making the offer which in the extreme case can save the loser all his opponent's costs.

There is clearly an incentive to make Part 36 Offers as early as possible in the case assuming the offers are not accepted, since that way they maximise the period of applicable costs for saving or indemnity boost. However there are two potential costs to making a Part 36 Offer. The first is that the offer may be made at the wrong rate and accepted by the opponent. Secondly, the offer may be made at the right rate given current information, but subsequent information may make this the "wrong rate" and the offer then accepted on this basis. In other words making a particular

Part 36 Offer also gives the opponent the option to stop you making other later offers or of progressing to trial.

Whenever a party makes a first Part 36 Offer, its expected legal costs fall and the expected legal costs of the other side rise, if the offer is not accepted. If a party makes a subsequent Part 36 Offer then the same effect occurs as long as the offer is better for the other side than previous offers made by that party. Fig. (6a) shows an example Part 36 Offer made by C. Initially C expects a trial payoff of £7 and legal costs of £4. After the Part 36 Offer C expects his total legal costs to fall to £2. Initially D expects a trial payout of £2 with own legal costs of £4. After C's part 36 Offer, D expects his legal costs to rise to £4. Hence in the example C's Part 36 Offer increases the SAF, SOF intersection from c. £4.5–c. £5.7.



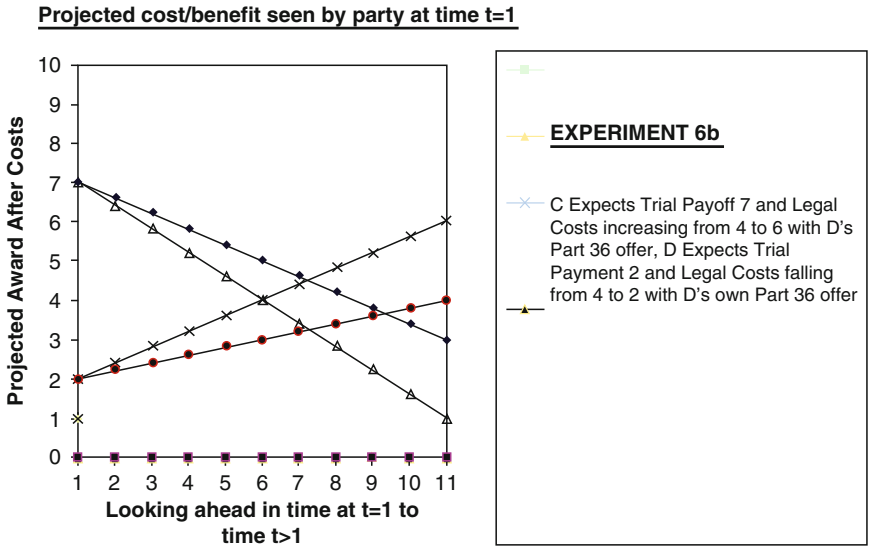
Clearly when it wants to make a Part 36 Offer, C determines the level of the Offer and the expected effect this will have on the SAF and SOF curves. If C's Part 36 Offer is very high, say 10 then the chance of it being accepted is very low and its expected effect on both C and D's expected legal costs is almost zero. The Offer can safely be made by C in the absence of any associated costs, but it has little benefit to C and the original settlement equilibrium at c. £4.5 will be unaffected. It is not equilibrium for D to consider accepting such an offer.

If C's Part 36 Offer is very low, say £1 then it has almost no chance of being refused by D. Both C and D now expect the settlement amount to be at C's new low Part 36 Offer. Hence both parties' expected legal costs thus become zero and flat and SAF and SOF can only intersect if counterfactually, both parties expected payouts at trial are now the same as the new Part 36 Offer value. Put another way, it is not equilibrium for C to make such an offer as it needlessly gives up value for no

benefit and hence such an offer cannot be made by C. Hence feasible offers much be somewhere in the vicinity of the pre-existing intersection of SAF and SOF.

Since any Part 36 Offer in this region by C must shift both SAF and SOF upwards as in Fig. (6a), this gives a method of determining what Part 36 Offer C should make. Specifically C should offer an amount that corresponds to the expected new intersection point of SAF and SOF, given that offer. The reason is that this Part 36 Offer is consistent for all parties. Therefore in Fig. (6a) C's recommended Part 36 Offer would be: c. £5.7, i.e. considerably higher in Cs favour than the £4.5 prior intersection point of SAF and SOF curves. Thus C has an incentive to make such an offer as it boosts his expected pre-trial settlement.

By a similar logic, D also has an incentive to make a Part 36 Offer around £3.3, i.e. lower than the original SAF: SOF equilibrium of c. £4.4.



Thus both C and D have an incentive to make their own Part 36 Offers and the optimal response to the other side's Part 36 Offer may indeed be an alternative Part 36 Offer at a different rate. There may also be a benefit in parties making a sequence of "out of the money" Part 36 Offers to partially insure their cost liabilities in case of exceptionally disadvantageous final judgement. However, if repeat Part 36 Offers are made by the same party, so the marginal benefit in terms of expected legal cost savings if the new offer is rejected also falls. This in turn will limit the optimal number of Part 36 Offers per party.

A key feature of Part 36 Offers is that there is typically only a short window for them to be accepted. This encourages the offeror since his risk that the offer was clearly made at the wrong rate increases over time as news on the case changes. The impact of news is that it will change the underling SAF and SOF curves and hence

the new optimal Part 36 Offers that can be made on both sides. Therefore the longer the case and the more variable the news in the case, so the more Part 36 Offers would be optimal and the more one would expect to observe.

7.9.1 Lessons from Analysis of Part 36 Offers

The following conclusions can be drawn from the discussion of Part 36 Offers:

122. Part 36 Offers have the benefit of making expected legal cost curve of the offeror more shallow and the expected cost curve of the offeree more steep, if not accepted. Thus Part 36 Offers move the local equilibrium settlement amount in favour of the offeror.
123. A Part 36 Offer made well within the relevant acceptance zone of the offeror, has little chance of being accepted and hence little impact on expected cost curves and hence on the intersection of SAF = SOF.
124. A Part 36 Offer made well outside the relevant acceptance zone of the offeror, is almost certain to be accepted and hence has a huge negative expected effect for the offeror on expected settlement. Such an offer cannot therefore be made.
125. The optimal Part 36 Offer is thus characterised by being approximately at the SAF = SOF intersection level, conditional on the new offer having been made.
126. The optimal Part 36 Offer is thus more beneficial to the offeror than the focal settlement amount X that exists without a Part 36 Offer. This gives the offeror the incentive to make such a Part 36 Offer.
127. The maker of a Part 36 Offer has to factor in the impact of potential news and developments in the case into his offer.
128. This is likely to make him want the offer to be open for as short a time as possible while still qualifying as a valid Part 36 Offer, i.e. 21 days.
129. The longer the offer open-window and the more variable the flow of background news in the case, then the greater the risk that any given offer rate will during the open-window period, become the "wrong rate". Therefore the more variable the news background so the more advantageous to the offeror the offer rate has to be. This is adding an extra (irreversible disinvestment) option premium on to the offer rate. It can also be seen as an extra insurance premium the offeror has to be paid to accommodate this risk.
130. One danger of a Part 36 Offer is that the offeror may have miscalculated the offeree's SAF or SOF and hence may pitch the Part 36 Offer at a level below the best rate it could attain. This feature may need to be factored into the offer made by moving the offer in favour of the offeror.
131. It may be sensible also for both parties in any event to make a sequence of "out of the money" Part 36 Offers to give them some insurance against unexpected highly adverse outcomes at trial and additional offers in response to news in the case.

132. It is unlikely to be optimal for parties not to make Part 36 Offers, particularly at "out of the money" levels.

7.10 Standard Settlement Offers Made "Without Prejudice" or Publicly

Part 36 Offers are distinct from other, Standard Settlement Offers (SSOs), when formally labelled and categorised as such and in as much as they have a minimum acceptance window and a clear expected direct impact on legal costs on both sides both before and after trial, as discussed above. Part 36 Offers are effectively "without prejudice" during the litigation and trial process, but revealed to the court thereafter, for cost considerations. The availability of Part 36 Offers does not however mean that SSOs cannot be made either additionally or alternatively and publicly or "without prejudice".

A general principle applicable to all offers including SSOs is that the longer the offer window is open, so the more beneficial a fixed offer has to be in favour of the offeror to compensate the offeror for the risk that news developments during the open-offer period suddenly makes the offer look excessively generous.

However, the more beneficial the offer rate to the offeror, so the less likely it is to be accepted by the offeree, ceteris paribus. Conversely, the longer the open-offer window, ceteris paribus, the more likely any offer is to be accepted by the offeree. Hence there is a tradeoff for SSOs between open-offer period and attractiveness of a fixed offer rate.

What this means is that where Part 36 Offers can be used for offers with longer open-offer windows, with their enhanced cost benefits for the offeror, so SSOs are likely to be additionally used for offers with shorter open-offer windows, which do not make the Part 36 minimum time limit. It is theoretically possible for a party to have a strategy of one or more Part 36 Offers combined with one or more SSOs. A Part 36 Offer and SSO could overlap with different offer rates corresponding to the different start dates and open offer periods.

If SSOs are made with shorter open-offer periods, then a balance has to be struck between (1) forcing the opponent to take the offer seriously and accept the offer during the timeframe, on the basis that it might not be repeated and (2) giving the offeror the option to make subsequent offers if desirable, without losing credibility. If there were no other offers on the table then an SSO might be framed as a final offer. If the offering party was an intimidator then this might additionally increase the risk premia of the opponent and make the SSO more likely to be accepted.

SSOs can also be made publicly. The advantage of this strategy is that the opponent cannot pretend that he has not received such an offer and the court can factor a public SSO into any cost awards made at the end of trial, as it would for a Part 36 Offer. The danger of a public SSO is that it might be construed as an admission of liability or defeat and it might also compromise any line of without

prejudice communication between the parties and any other without prejudice SSOs or Part 36 Offers. If these dangers could be neutralised however, then public SSOs would become very attractive because they could then be made with much shorter open-offer windows and hence at more attractive rates to the offeree than Part 36 Offers and yet still impact final cost awards in a similar way.

7.11 Time and State Contingent Offers

The discussion so far has assumed the use of fixed offers open for fixed time periods. Typically an open offer can be withdrawn by the offeror. It is therefore effectively callable, i.e. a contingent offer. If the offeror is unlikely to withdraw his open offer, for credibility reasons, then this call option is an outside or out-of-the money option, but should not be ignored. It is logically possible for this option to be removed, e.g. by a collateral contract between the parties for the offeror to keep his offer open for the specified time. The offeree would need to pay the offeror a positive amount for any such collateral contract. Alternatively, the offeror would need to make a less favourable offer to the offeree. Hence the flexibility of the call option allows the offeror to make a better offer to the offeree, from the offeree's perspective than he otherwise would.

The general principle is that the more news-risk the offeror can be protected from in his offer, so the less risk allowance and risk premium the offeror needs to build into his offer so the more attractive an offer can be made to the offeree and the more likely the offer is to be accepted, ceteris paribus. This implies that if offerors use more state-contingent offers that cap or reduce their risk, so they can make better (for the offeree) and longer, open-offers that are more likely to be accepted ceteris paribus. Thus state-contingent offers can be made whose exact rate depends on both time and the level of other variables either observable concurrently or in future. One example would be an offer to buy shares over period x at the previous day's closing price +1% up to a maximum price of $100; another would be to pay 80% of the medical bills incurred over the next year up to a limit of £1 M.

7.12 Legal Aid Awards

In England and Wales, Legal Aid is available for a limited number of deserving civil claims and for criminal defence. In criminal cases, Legal Aid gives the client an incentive not to plead guilty but to contest a trial whatever the evidence and therefore the incentive to generate a suboptimally excess number of criminal trials and excess criminal trial expenses. To counterbalance this effect, clients facing criminal charges who plead guilty and thereby avoid the expense of a trial are given a credit reduction of up to one-third off their sentences. Hence the market imperfection of Legal Aid tending to create excess not guilty pleas and contested criminal

trials, is offset to a degree by the market imperfection of charging guilty criminals extra sentence time for persisting with the trial process, ceteris paribus. Unfortunately, what this inevitably logically means is that at least one or both of these two groups of guilty criminal Defendants must be receiving sentences that are strictly incommensurate with their crimes.

For civil Claimants who are eligible, the impact of Legal Aid on the recipient will be to reduce his perceived legal cost, i.e. to reduce the cost time pressure on him to settle and also to move the equilibrium settlement amount in his favour. This support can be illusory however and lull the party into proceeding with the case when he otherwise should not. This is because for civil cases, the government subsequently tries to recoup its Legal Aid contribution from any winnings in the case. On the other side of the case, the opponent facing a legally aided client knows that there is little prospect of recouping his own legal costs even if successful. This in turn increases the net expected legal cost curve for the non-legally aided opponent. Thus the impact of Legal Aid in the civil sphere is to generate more claims by legally aided Claimants and to move settlements in favour of the legally aided Claimant, who may in turn lose some of his settlement to the government. The incentive to excess litigation caused by Legal Aid is mitigated by its restricted availability.

A nightmare Legal Aid scenario has occurred in certain fraud trials where the Defendant is formally legally aided and the Crown behaves as though it is legally aided. The nature of these particular cases means that the harder they are fought, the more complex is the evidence reviewed by the jury and the lower the likelihood of conviction to the criminal standard of certainty. In other words these are Legal Aid cases where the decrease in probability of conviction from contesting the case far outweighs the value of any loss of credit for an early guilty plea. Not surprisingly, such cases, creating a huge cost to the taxpayer and wealth transfer to the lawyers ceteris paribus, with little actual or deterrent effect on crime, have brought the Legal Aid system into disrepute.

7.13 Conclusions

Starting with a simple economic model of the value of civil litigation from each side's perspective, this paper analyses a wide range of potential litigation cost strategies, settlement offers and negotiations, together with relevant applications and insights from game theory. Specific issues examined include: optimal settlement agreements, optimal settlement timing, optimal choice of lawyers; principal–agent problems aligning lawyer cost incentives; optimal client–lawyer contracts; "Conditional Fee Agreements" (CFAs); success rules and size of success premia; the exploitation and mitigation of liquidity and bankruptcy constraints; impact of collateral, "Security for Costs" and "Freezing Orders"; optimal "Part 36 Offers"; public and "without prejudice" offers; fixed rate and state-contingent offers; the role of mediation and alternative dispute resolution (ADR); the effect of litigant

group size, co-ordination and class actions; rationale for confidential no-liability settlement agreements; effects of legal aid; time-value to trial and "optionality" of news; the impact of the "Law of Costs"; optimal trial cost applications and requests for "leave to appeal". Both familiar and paradoxical new results are confirmed by the analysis. Specific examples are considered from the law and practice of England and Wales but the fundamental principles derived are applicable, mutatis mutandis, to all other related legal systems including American and Commonwealth.

7.14 Postscript: Trial Applications for Costs and Leave to Appeal

If a civil case runs to trial, judgement will be given and an order made as to costs. Before this happens, both sides get a chance to argue before the judge on the allocation of costs and to present their case as to why the opponent should pay more and the client less. The time window to make these cost applications in court is typically short and the effect on costs payable potentially enormous. This suggests that in equilibrium, barristers should allocate as much time to the prior preparation of their cost submissions, so that any marginal work on cost saving has the same expected marginal benefit as expected marginal cost.

Additionally as the cost to the loser of the current trial rises, so the option value to him of a successful appeal to the next court up to reverse that decision, also rises. This in turn means that the marginal value to the client in using a barrister who can immediately generate grounds for and request leave to appeal if necessary at the end of a trial, also rises. This is additionally consistent with increasing marginal cost and quality of lawyers up to and including the trial stages.

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Chapter 8
A Cognitive Approach to Judicial Strategies: A Perspective from the French Business Environment*

Didier Danet

Abstract French public opinion has long been disenchanted with its judicial system. Throughout history, popular images of Justice have usually been negative ones. In many cases, judges are shown to be partial, incapable of establishing truth or subject to the most powerful institutions. This poor image of Justice has significant consequences on the opinion of business people and on corporate judicial strategies: from prioritising out of court settlements, to deterring the opposing party from asserting its rights, and by the taking advantage of the slowness, costs and hazards of going to the public court.

8.1 Introduction

French public opinion has long been disenchanted with its judicial system. One exception to the rule: Louis IX. This thirteenth century king of France is known for his image of piety and justice. The popular iconography shows him as an approachable and fair judge, sitting under an oak tree in front of the royal castle of Vincennes, making equitable and impartial judgments. However, Louis IX is a remarkable but isolated exception to the rule. Throughout history, most of the popular images of Justice have been negative ones. In many famous cases (Joan of Arc, Nicolas Fouquet, Jean Calas or Alfred Dreyfus for example), Justice is shown to be partial, incapable of establishing truth and subject to the most powerful institutions (for example, Church, Government, military hierarchy, etc.). The great French writers are usually severe with judges and the judicial system – La Fontaine,

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Pascal, Hugo, Zola – all of them protest against the miscarriages of Justice and share the same message: "Selon que vous serez puissant ou misérables, les jugements de cour vous feront noir ou blanc".[1] Not so long ago, the "legal disaster" of the so-called *Outreau* case created a general feeling of "yet again".[2]

Such a negative and constant representation of Justice makes public opinion suspicious or even scared of the judicial system. Most opinion polls confirm this point. Insofar as individuals cannot choose their judges, this distrust is of no great practical consequence. However, in the particular case of commercial litigation, companies have an unquestionable freedom to tailor legal arguments or even to organize their own justice outside of the judicial courts and the rules of procedure. The image of Justice is then of great importance because it influences and perhaps even determines the strategic behaviour of these companies with respect to the problems they face in the business world. The starting point of this paper is an examination of the representation of Justice in French public opinion, particularly with respect to the opinion of business people. Does public opinion have a positive or negative image of Justice? What are the perceived characteristics of the judicial system? Do judges make good or bad decisions? Within this general image of Justice, the opinion of experts and business people is emphasised. In the second part of this paper, the strategic behaviour of companies vis-à-vis Justice is analysed. Strategies which come into play prior to the lawsuit are distinguished from strategies which tend to manage the lawsuit. Both these strategies are influenced by the representation of Justice.

8.2 Representation of Justice, Public Opinion and the Opinion of the Business Community in France

Apart from the general feeling referred to at the beginning of this paper, what do we know about the representation of Justice according to French public opinion? More precisely, what do business people think of the judicial establishment they are working in?

[1] "According to whether you are powerful or poor, the judgments of courts will make you black or white".

[2] The *Outreau* case, described in a Parliamentary Inquiry Commission report as a "legal disaster", saw six out of ten individuals convicted for paedophilia, acquitted by the Court of Appeal of Paris. The six had always maintained their innocence. For further discussion see, A. Vallini, and P. Houillon, "Rapport fait au nom de la commission chargée de rechercher les causes des dysfonctionnements dans l'affaire dite d'Outreau et de formuler des propositions pour éviter leur renouvellement" (6 juin 2006) Rapport d'enquête No. 3125(Assemblée nationale, 2006), online: N° 3125 http://www.assemblee-nationale.fr/12/rap-enq/r3125.asp.

8.2.1 Justice and Public Opinion

The Representation of Justice is the subject of many opinion polls. Most of these polls are designed and published on the occasion of crises. The opinion of people is polled when a serious crime is committed and questions are asked such as: Is Justice severe enough with recidivists or when riots occur in the suburbs? Should under age people be jailed as adults are? When an innocent person is sent to prison for many years should judges be responsible in the case of a miscarriage of Justice? The results of such polls can generally be considered biased. But, even if most of the results are distorted, some reliable studies bring to the fore three main conclusions about Justice in France.

8.2.1.1 Justice: An Unknown Institution

In 2004, according to the CSA Institute, an opinion poll and market research company, only one third of the respondents agreed with the following statement: "I am (well or quite well) aware of the way Justice works".[3] A further question revealed that people know the main players of the judicial process, i.e. judges and barristers especially. However, they fail to recognise the technical wheels of Justice, i.e. attorneys, clerks or plaintiffs.

8.2.1.2 Justice: The Worst Reputation Among Public Services

In a recurrent study, "French people and their public services", the CSA Institute asks respondents to assess and give a good or bad mark to public institutions. Justice is awkwardly ranked among services which are in competition. In the years 2000 and 2002, it received the worst mark of all these services and in 2005 ranked second last. Justice comes far behind city councils or hospitals – the usual favourites in the polls – and it is also overtaken by social services and even the tax authorities. In 2002, Justice was the only public service whose mark was lower than the average, decreasing from 9.8 to 9.2.[4] In 2005, its mark actually increased to 10.2 while the Employment Agency dramatically fell at the same time. Yet, this relative improvement seems to be very fragile. On the one hand, the unemployment rate has been declining for many months which should improve the image of the Employment Agency. On the other hand, Justice as a whole is involved in the turmoil of the *Outreau* case in which individual errors and institutional failures followed one another and brought deep discredit on the magistrature. Justice will most likely

[3]CSA, Les Français et la Justice, Sondage CSA: Sélection du Reader's Digest, realized the 29th of July, 2004 [Sondage CSA 2004].

[4]CSA, Les Français et leurs services publics, Sondage CSA: Reader's Digest, realized the 30th of September, 2002.

once again rank the lowest in the next poll. According to another poll institute, public opinion considers that Justice works worse than before (53%) and that the way it worked in 2004 is bad or very bad (70% in 2004, 62% in 2002).[5]

Both polls lead to the same conclusions with regard to the grievances against Justice. Almost all the respondents agree on the following statement, a "lawsuit is an expensive process" (89%) and disagree on these two: "Justice works quickly" (87%) and "Justice speaks clearly" (81%).

These conclusions are nothing but astonishing. Even more interesting however, is the poll carried out by the CSA Institute which distinguishes between two sample groups: "ordinary" people and people faced with a problem requiring the intervention by Justice. This second sample forms a kind of "enlightened" opinion which has been in contact with Justice and directly informed of judicial proceedings. When the results were compared, no significant differences appeared in the answers by the two sample groups. People who experienced judicial procedures were as hard as others on the way Justice works: slow (88% vs. 89%), costly (84% vs. 89%), unclear (88% vs. 89%). This experience unfortunately confirms the prejudice and reinforces the widespread maxim: "better a bad deal than a good lawsuit". However, 80% of the "ordinary" people endorsed this view with only 69% support from the "enlightened" opinion. The gap here is quite significant and seems to indicate that Justice is more effective than ordinary people at first believe it to be. However, it should be observed that this positive result is also very fragile since a wide majority of respondents who have previously been in contact with Justice are inclined to later settle a deal, even if it is a bad settlement.

8.2.1.3 Justice: A Trustworthy Institution?

The result of the latest poll proves that French people do not fully trust Justice. Justice is usually considered more reliable than media or politicians, both of whom have lost most of their credibility. However, it is considered by far less trustworthy than armed forces or teachers. In another poll recently published by the CSA Institute, respondents put Justice, banks, company executives, and newspapers in the same category.[6] Regardless, it seems that this intermediate situation for Justice is quite stable: about 50% of French people did not have confidence in Justice in 1994[7] as well as in 2004.[8] According to French public opinion, truth does not always become apparent to judges and they also fail in their duty to take into account the position of victims. The image of judges is quite mixed: they are held to

[5]TNS Sofres, Les Français et la Justice, Sondage TNS: Sofres Le Figaro Magazine, realized the 13th and 14th of October, 2004 [Sondage TNS].

[6]CSA, Les personnes ou organismes inspirant confiance aux Français, Sondage CSA: La Vie, realized between the 17th and the 19th of August, 2005.

[7]IFOP, La Justice, Sondage IFOP: Journal du Dimanche, realized the 17th and the 18th of November 1994 [IFOP].

[8]Sondage TNS (n 5).

be technically skilled, but doubts remain as far as their political independence, their fairness or even their honesty is concerned.[9] Less than half of public opinion agrees with the following sentence: "an innocent person does not have anything to fear from Justice". Further, more than 50% would hesitate to sue a person responsible for a damage-related offence. They also would fear Justice if they had to deal with it.[10]

8.2.2 Justice and Experts

The poor public opinion of the representation of Justice is strengthened by assessments of experts such as the World Bank. Its famous *Doing Business* report answers questions beyond the efficiency of judicial processes. For example: "Are there significant differences in business regulation from country to country? If so, what explains these differences? What types of regulation lead to improved economic and social outcomes? What are the most successful regulatory models? More generally, what is the scope for a government in facilitating business activity?"[11] However, two series of indicators are closely related to the question of efficiency in the administration of Justice: "Enforcing Contracts"[12] and "Closing a Business".[13]

Regarding the implementation of contracts, the indicators of *Doing Business* relate to the number, duration (days) and cost (percentage of debt) of procedures. As far as the two last indicators (duration and cost of procedures) are concerned, a few countries (Japan, USA, Sweden, Denmark) have an advantage over France: contract implementation is quicker and less expensive. On the other hand, the French judicial process is more efficient than others (Greece, Italy, Netherlands and Portugal) on this point. In some cases, arbitration has to be provided: quicker recovery can mean higher cost (Ireland, UK) but lower cost might mean longer procedure (Austria, Germany). The comparison leads to mitigate one of the main grievances against Justice. In most countries, the implementation of contracts is not both expensive and slow; neither is it swift and cheaper.

Regarding the administration of bankruptcy, the *Doing Business 2006* report confirms the calamitous image of French Justice and the obvious failure of the legal rules in that specific area of positive law. With a few exceptions (Greece, Italy and Germany), the position of creditors is far weaker in France than in other countries: the recovery rate is dramatically lower (48% vs. more than 75% everywhere else). Further, the procedures are often longer and more expensive than in other countries

[9]Sondage CSA 1997 (n 6); IFOP (n 9).

[10]Ibid.

[11]World Bank, *Doing Business in 2006, Creating Jobs* (Oxford University Press, 2006) Foreword, p. XIII.

[12]Ibid 61–66.

[13]Ibid 67–71.

(Belgium, Japan, UK, USA) with a few exceptions (Greece, Portugal, Sweden). In short, the judicial system is neither effective nor efficient. For the last two or three decades, the main aim of bankruptcy legislation has been to maintain employment even if it operates to the detriment of creditors (associated with a risk of bankruptcies in succession). This obvious failure harbours grievances against commercial Justice.

Quite often, courts and judges are blamed for being incompetent and corrupt. For example, in 1998, a report by MPs François Colcombet and Arnaud Montebourg violently criticised commercial courts and in particular, elected judges. Some of the headings in their report included: "failing and out of control", "from neighbourhood to cousinhood", "emergence and development of corruption in commercial courts".[14] However, a later report by Senator Paul Girod clearly demonstrated that these criticisms were excessive and sectarian[15] – commercial judges can not be held responsible for all companies that go into liquidation and pass away. That being said however, because of these criticisms, the image of commercial courts is still worse than the reality described by the World Bank reports.

8.2.3 Justice and Business People

The results of the polls make it possible to isolate the opinion of business people on Justice.[16]

The first conclusion that can be made is that business people seem to know how Justice works a little better than the other socio-professional groups. Interestingly, two thirds of them answer that they know little about Justice which is almost within the average of the population. Beyond that general feeling of shared ignorance however, business people have more knowledge than others regarding the players in the judicial process. For example, about 80% know the meaning of judge, barrister or bailiff. This last example is quite significant as the gap with other groups reaches almost twenty points. Such a gap might indicate that business people use the services of legal advisers in their current professional environment, especially during the first stages of commercial disputes. For ordinary people, the bailiff is simply the individual who seizes the wealth of those who do not pay their debts. For business people, the bailiff is an individual who, for example, delivers deeds with solemnity or establishes certified statements. The bailiff is part of every day business life.

[14]F. Colcombet et A. Montebourg, "Rapport sur l'activité et le fonctionnement des tribunaux de commerce" (3 juillet 1998) Rapport No. 1038. (Assemblée nationale, 1998), online: Assemblee nationale http://www.assemblee-nationale.fr/11/dossiers/Tribunaux-de-commerce.asp.

[15]P. Girod, *Projet de loi portant réforme des tribunaux de commerce* (23 janvier 2002) Sénat Rapport no. 178, online: Projet de loi http://www.senat.fr/rap/l01-178/l01-1780.html.

[16]Sondage CSA 2004 (n 3).

The opinion of business people is more severe than other socio-professional groups with regard to miscarriages of Justice. From 2002 to 2005, even though public opinion was a bit more indulgent to Justice, the mark given by business people was lowering. Several indicators evince this increasing distrust. More than others, business people assert that Justice treats every citizen equally and that penalties are severe, obviously rejecting the common representation of judges favourable to the rich and powerful ones. However, business people also appear to believe that they are targeted by judges, especially when corruption cases are brought to courts. During the 1990s, many political parties were sued because of illegal fund raising methods: overbilling, faked bids in public markets, fictitious jobs for example. Although both politicians and executives were responsible for these blameworthy practices, Justice mainly attacked the executives, charging them with misappropriation of corporate funds and changed the corrupter into nothing more than an abettor. Whereas politicians were often treated leniently, judges pronounced many sentences against executives and corporations, some of them based on debatable reasons.[17] Such unfair treatment is likely to have left a deep impression among business people – bitterness against politicians and distrust towards Justice.

8.3 Representation of Justice and Corporate Judicial Strategies

A company which does not build a judicial strategy is bound to "undergo" Justice.[18] In some cases, no choice is possible. Public order is at stake and companies are obliged to submit themselves to procedures that are outside of their control. For instance, when a commercial court declares a company insolvent, executives are sidelined and do not really take part in the course of the proceedings. On the contrary, when public order is not at stake, companies can take advantage of implementing strategies which integrate the representation of Justice. Some of these strategies may of course be aimed at avoiding such a failing and distrustful machine. While these are unquestionably the most and best known of all judicial strategies, some strategies may also rely on the deficiencies of Justice to improve the situation of the company.

[17]B. Bouloc, Note sous Cass. com. (27 octobre 1997) Carignon, Dr. Sociétés 869; See also L. Saenko, "La notiçon de dissimulation en matière d'abus de biens sociaux" (2005) Revue Trimestrielle de Droit Commercial 671.

[18]C. Champaud et D. Danet, *Stratégies judiciaires des enterprises* (Dalloz, 2006); See also J. Paillusseau, "Le droit est aussi une science de l'organisation" (1989) Revue Trimestrielle de Droit Commercial 1–57; See also J. Saporta "La place de l'environnement stratégique dans la démarche stratégique de l'entreprise" (18 septembre 1987) Petites Affiches, No. 112.

8.3.1 Avoiding Justice

If Justice is held to be slow and inefficient or even hostile to business people, the most natural corporate strategy is to avoid public judges whenever possible. These avoidance strategies must still abide by public order rules but companies have a lot at stake when planning a procedure or choosing the court which will settle their case.

8.3.1.1 Designing the Procedure

Sometimes, public Justice cannot be put aside. Thus, the company must seek to consolidate its position. This enforcement strategy consists in organizing litigation beforehand so that it can take place on the most favourable basis. For example, the company proposes a legally reasoned argument that Justice will consider without acknowledging the fact that this position often originates from a higher economic power. The weight of inequality is particularly obvious when the type of lawsuit arises from contractual provisions. Imbalance however is less obvious when the stronger positions are derived from an established arrangement of property rights or economic control arrangements.

A contractual arrangement is always ambivalent. It is comprised of convergent and divergent interests in flux. During the negotiation stage, social environment and future prospects of profit can lead a signatory to underestimate the extent of certain clauses for jurisdictional purposes. Indeed, such clauses can aim at claim to put the author of the clauses, at the appropriate time, into a position of advantage in a dispute settlement. These can be gathered in two main categories.

The clauses for jurisdictional purpose make it possible to choose the judge or to oblige the judge to rule in favour of their author. These clauses withdraw the litigation from its "natural judge" and submit it to a supposedly more favourable situation. The shift of the litigation can take place in two different ways: *ratione materiae* and *ratione loci*. In *ratione materiae*, the clauses of contractual extension transfer the litigation from a public judge to another public judge, of the same status, but of a different jurisdiction. While, the rules relating to the jurisdiction of the courts belong to law thus confining order and extensions within narrow limits, such clauses are not completely prohibited. For example, a contract can stipulate the jurisdiction of the County Court for litigation involving small amounts. Due to these types of clauses, most potential adversaries will hesitate because of the expenses incurred due to the need for a lawyer. It also allows the company to reserve the possibility of lodging an appeal. Further, even if the validity of the clause is doubtful, it complicates the lawsuit and supports the most powerful party.

Similar results can be obtained thanks to the clauses of *ratione loci* competence. Here, the author of the clause endeavours to benefit from the differences in litigation settlement which can be related to local characteristics. Thus a company can prefer to stand trial in its "fief", i.e. a socio-economic environment where its weight will be, at least implicitly, taken into account. It can also ask for the

procedure to take place before such Court of Appeal known to allocate more substantial damages than another court.

Contrary to the clauses for jurisdictional purpose, the reservation of rights arises as contractual provisions similar to those relating to the conditions of the obligation or the conditions of validity of commitments. They do not seem to relate to procedural rules. However, these clauses always reveal a more or less subtle and effective, but deliberate, judicial strategy. They often relate to property rights and the contractual organization of civil liability. In both cases, company strategy consists of reinforcing its position by an *ad hoc* contractual arrangement. For that purpose, the company will insert some clauses into the contract, the effect of which is to counter certain fundamental rules of property and contract rights. This modification confers a strong advantage in favour of the author of the clauses.

For example, the company which sells a good can design the mechanism of the transfer of property while inserting a clause of reservation of title. If the buyer does not pay the price, the company will be able to go to court like an owner of the good and not as the creditor of a person who has been adjudicated a bankrupt. The question put to the court will be that of the restitution of a good to its legitimate owner and not that of the forced payment of a due sum. It is known that in France, the rights of the owner are infinitely stronger than those of the creditor. Thus a claimant can avoid costs and delays as described by the World Bank even if the debtor is bankrupt.[19]

These strategies are also very important with regard to adjustments of contractual liability.[20] The company can avoid many lawsuits by imposing restrictions on the other contracting party: shortened time limits on a claim for damages, total or partial exemption, contradictory expertise, and various formalities, for example.[21] Due to these types of contractual provisions, the action of the victim is hampered and made more expensive, which can actually deter many actions when the adversary becomes aware of the brittleness of his position.

8.3.1.2 Avoiding Public Justice

By choosing arbitration, companies clearly seek to avoid public courts.[22] Arbitration consists in giving individuals the right to settle a dispute.[23] Just like members

[19]F. Perochon, Note sous Cass. com. (8 juin 1993) (Dalloz, 1993), Somm. 296.

[20]J-P. Chazal, "Théorie de la cause et justice contractuelle, à propos de l'arrêt Chronopost" (1998) JCP, I, 152; See also J. Ricatte "A propos de l'option Effacement jour de pointe dans les contrats" (1988) EDF, JCP-E, II, 15247.

[21]P. Malinvaud, "Pour ou contre la validité de clauses limitatives de la garantie des vices cachés dans la vente" (1975) JCP, I, 2690; See also J. Bigot, "Plaidoyer pour les clauses limitatives entre professionnels" (1976) JCP-G, I, 2755.

[22]K.N. Hylton, and C.R. Drahozal, "The Economics of Litigation and Arbitration: An Application to Franchise Contracts" (2001) Boston Univ. School of Law, Working Paper No. 01-03.

[23]J. Robert, *L'arbitrage* (Dalloz Sirey Traités, 1997); See also E.L. Rubin, "The Non Judicial Life of Contract: Beyond the Shadow of the Law" (1995) 90 Northwestern University Law Review

of the judiciary, arbitrators hold the power of *jurisdictio*. When they pass a sentence, they express a "social truth" which supersedes the "factual truth". Arbitration processes present three fundamental characteristics. First of all, arbitration is entirely rooted in a contractual approach to Justice. The will of parties plays a dominating part until adjudication. In most cases, the commercial contract includes a special clause: the signatories decide to forego recourse to the court in the event of conflict and agree on the designation procedures of arbitrators. In other cases, arbitration is implemented when conflict arises. A specific agreement is signed which aims at leaving aside the intervention of the judge who would normally have heard the dispute. In both cases, the arbitration court is composed of arbitrators who are chosen by the contracting parties.

Arbitration may be considered as a response to the bad reputation of the courts. Courts are criticised because the legal proceedings are slow, expensive and obscure to the people who have to deal with them. In this respect, the arbitration procedure presents several advantages.[24]

The first of these advantages is confidentiality. The public does not have a right to access arbitration audiences and sentences. Only the parties can lift the veil of secrecy on the arbitration hearing and the result of the arbitration process. By contrast, any court decision can be freely published, commented on, even circulated to the media and the parties can be identified. Anyone can discover in the newspapers or in law reviews: the names, circumstances and terms of the litigation; the industrial, financial or commercial stakes; and the sentence passed by the court. That being said, arbitral confidentiality can be lost if one of the parties decides to appeal against the decision.

The arbitration has a second advantage: decisions are made quickly. Except for a provision to the contrary, a decision must be made within the six months following the day when the last arbitrator has accepted the case. Many decisions are returned by the six month deadline. An arbitration will seldom last more than 18 months. By comparison, parties can hardly hope for a public judgment in less than 12 months and it is common for the process to stretch over years. *Ceteris paribus*, an arbitration procedure takes five to ten times less time than its judicial counterpart.

From the parties' standpoint, one of the most important characteristics of the arbitration procedure is freedom to choose the arbitrators. In most cases, the arbitration court is composed of two judges appointed by each party, with these two judges then choosing the "president" by mutual agreement. This faculty of choice is very important since it has as an immediate outcome: the implementation of a competitive process which leads to the "natural" selection of the arbitrators, with some being accepted and some rejected.[25]

107; See also S. Shavell, "Alternative Dispute Resolution: An Economic Analysis" (1995) 24 Journal of Legal Studies 1.

[24]R.A. Bales, *An Introduction to Arbitration* (March 2006) Kentucky Bench & Bar.

[25]See D.E. Bloom, and C.L. Cavanagh, "An Analysis of the Selection of Arbitrators" (1986) 76 American Economic Review 408.

Last but not least, arbitrators are close to the parties. Unavoidably, court bearing is affected by the distance placed between the parties and the judge. Legal proceedings, as far as possible, appear impartial, but also appear enigmatic and indifferent. Even the presence of a barrister, who typically speaks the same esoteric language as the judge, plays a part in the reinforcement of the distance between the parties and the judge. To the contrary, in the arbitration procedure, the parties can speak with judges chosen by them for their competence and who are more accessible than public judges. These arbitrators will pay all the more attention to the parties as they are in a process of competition.

8.3.2 Using the Bad Image of Justice

The bad image of Justice can cause companies to be wary of it, possibly to the extent of avoidance. On the other hand, the bad image of Justice may also appear as a lever in the strategic management of a lawsuit.

8.3.2.1 Taking Advantage of the Fear of Court Proceedings

The fear of recourse to legal proceedings is often used to test the forces of the opposing party and to deter it from beginning a long and expensive procedure. Graduated operations tend to intimidate the opposing party.

The most common tool used to threaten an opposing party is giving it notice to pay or fulfil the terms of a contract. This notice very often takes the shape of a registered letter requesting confirmation of receipt. Resorting to such a letter per se is common practice and does not truly frighten anyone in the world of business. However, this type of letter nonetheless exerts some pressure on the recipient because it potentially represents the first step of an escalation which can eventually lead to court. If the recipient's answer is not in the desired direction, the sender can renew the procedure through varying measures that become increasingly threatening. This strategy, however, appears to be of limited effectiveness because the repetition of the original non-effective threat loses its impact. It is thus necessary to arrive at a new step in the escalation – reinforcement of the threat in the letter by the intervention of a third person.

In the case of an unpaid debt, the creditor can call upon a debt collection agency. Individuals can be easily influenced by threatening formulas and quasi-official appearance of documents. This tool however is far less effective when it is used against companies. Hence it is necessary to take a pre-judicial step. Here, a bailiff's intervention might be requested. At this stage of the procedure, the bailiff will only carry out or deliver deeds on the basis of its function as a public officer which adds much solemnity. The intervention of the bailiff is likely to produce more intimidation if it consists in the drawing up of a certified statement. The observations contained in that statement are of legal effect if the case is referred to the

appropriate jurisdiction. It constitutes a more credible threat than ordinary testimony. Turning to a barrister would be the next step in the escalation – the last one before a lawsuit. The deontology rules forbid the lawyer from addressing a threatening letter to the adversary of its client. The lawyer cannot thus answer the grievances raised by the opposing party. However, paradoxically, this compelled laconism reinforces the intimidating impact of the letter in which the barrister requests the recipient to indicate "the name and the address of the colleague in charge of the defence of his interests".

Judicial appraisal can also be connected with these pressure strategies. In theory, the appraisal is not intended to intimidate the adversary of the claimant.[26] The procedures are conceived to facilitate the work of the judge by objectively establishing probable but unproven facts or unconfirmed calculations. However, judicial appraisal has three hidden effects. First, it enforces the credibility of the previous threats – bailiff or barrister. The claimant is actually bringing a lawsuit against the opposing party. While this action does not get to the bottom of the case, for the first time the case is actually referred to court. There is no more doubt that the claimant is ready to carry his threats into execution. Second, if an expert is appointed by the judge, the claimant hopes that the discovery application will be a source of annoyance and that the opposing party will negotiate rather than undergo unwanted investigations. Last, the expert's report may reveal pieces of information or facts that the opposing party would like to keep secret and which will be disclosed to all during the judicial lawsuit.[27] The notion of discovery is beyond a doubt a tool of intimidation. It is all the more powerful as its capacity as a threat remains widely hidden. A determined claimant will take advantage of Justice to put pressure on his adversary and to force him to reach a private agreement. Judges are naturally aware of these strategies. They try to limit their unwanted effects by laying down strict conditions to the action of the claimants. However, in spite of the restrictive jurisprudence, this expertise remains a privileged ground for skilful companies.

One cannot conclude a discussion on strategies based on fear of judges without mentioning the case of penal actions. For many socio-political reasons, French legislators let an ill-considered penalisation of business affairs to occur. Indeed, nothing is more frequent than a party who threatens to make a complaint against its adversary. However, if penal law provides many weapons for that purpose, the company wishing to resort to it should always give it second thought. The penal complaint is a powerful threat but it may have a boomerang effect and turn on the one who uses it. An improper complaint may entail legal proceedings against the unwise claimant (for example, slander, denunciation, blackmail) and lead to significant punitive damages.

[26]I. Urbain Parléani, "L'expert de gestion et l'expert *in futurum*" (2003) Revue Sociétés 223.

[27]C. Champaud et D. Danet D, Note sous Cass. com. (15 juin 1999) Fleury Michon, Revue Trimestrielle Droit Commercial 876.

8.3.2.2 Taking Advantage of the Slowness and Cost of Justice

Slowness, and its induced costs, is not necessarily the sign of a failing judicial system. To work properly, Justice needs time, weighing, and reflexion. Formalism of procedure is no vain luxury but the origin of fairness. However, a skilful plaintiff can convert these qualities into levers for delaying the normal processing of the case. When the strategic decision to delay the course of Justice is taken, the tactical means are countless.[28]

A first cause of delay, generally unknown to public opinion but widely practised, comes from barristers who do not present their requests and answers within the agreed time. In spite of the reforms requiring judicial deadlines to be observed, it is not rare for a party to obtain multiple adjournments of time under various pretexts. Sometimes judges pay attention to these dilatory tactics. Most of the time, however, permissiveness will prevail. Where there is a backlog of cases, adjournments lighten the load. As for the barrister of the party who accedes to the adjournment, he or she may need the understanding of his fellow members in the future. So, if not under pressure from the client, he or she may only half-heartedly oppose delaying tactics from the other side.

Another cause of delay lies in matters of procedure. These may occur throughout the proceedings. *In limine litis*, objections may come from the defendant. The aim here is to halt the action brought against him by the plaintiff. The defendant may plead a lack of jurisdiction of the court if the plaintiff has made an error or "forgotten" a contractual obligation such as an arbitration provision.[29] In this regard, the arrangements aimed at designing the procedure are of great importance. The defendant may also invoke the fact that another case has been referred to another court whose decision affects the case being heard. This objection will be successful if it appears to the judge that the two proceedings might lead to conflicting decisions.[30] A rare exception may occur where the good administration of Justice is at stake. For example, the defendant may summon a guarantor in the lawsuit. All these exceptions have to be agreed to at the beginning of the case, which will delay the judgment and discourage the opposing party.

During the lawsuit (even during the appeal) the defendant may ask the judge to dismiss the case on the ground that: the claimant is not qualified to act;[31] that he did

[28]Ph. Blondel, "Stratégie judiciaire", L. Cadiet ed., *Dictionnaire de la Justice* (PUF, 2004); See also L. Cadiet, *Droit judiciaire privé* (Litec, 2004); See also C. Champaud, "Stratégie judiciaire (Droit des affaires)" L. Cadiet ed., *Dictionnaire de la justice* (PUF, 2004).

[29]E. Locquin, "L'exception d'incompétence du juge étatique tirée de l'existence d'une clause compromissoire" Note sous Cass. civ. 2 (22 novembre 2001) Revue Trimestrielle Droit Commercial 46; See also, E. Locquin et J.C. Dubarry, note sous Paris (19 mai 1993) Revue Trimestrielle Droit Commercial 494.

[30]A. Marmisse, "La litispendance s'apprécie au regard des prétentions des demandeurs", note sous CJCE (8 mai 2003) Revue Trimestrielle Droit Commercial 607.

[31]Y. Chartier, "L'existence d'une action en justice au nom d'une SARL", note sous Cass.Civ.2 (22 octobre 1998) Revue Sociétés 76.

not take his opponent to court within the legally required time; or that he has signed an arbitration clause. The delay effect of types of submissions is doubtful. The judge is not compelled to examine them beforehand. The judge can raise objections to the case and include them in the decision. These exceptions are less effective than exceptions *in limine litis*.

In certain extreme cases, companies deliberately manipulate the contrast between the fast tempo of business and the slow tempo of Justice. The case *Les Trois Suisses vs. La Redoute* is a famous example of this common strategy.[32] In 1995, Les Trois Suisses, a mail-order selling company, launched an advertising campaign which was both comparative and aggressive. The target was its competitor La Redoute. Large advertisement boards were hung up side by side. The first one reproduced the competitor's slogan, "La Redoute delivers orders within 48 hours" but the original picture was tarnished by the use of dark and faded colours. In the second poster, the sun illuminated a bright coloured landscape and contained the following slogan, "Les Trois Suisses delivers orders within 24 hours". There was no doubt that this campaign breached the provisions of the Neiertz law which regulates comparative advertising in France. La Redoute immediately took summary action against Les Trois Suisses. The judge delivered a temporary injunction preventing the continuation of the campaign. In spite of the judgment, the aggressive strategy was successful. Thanks to the lawsuit, the media became interested in the case and widely relayed the advertisement. Les Trois Suisses did not omit to present their adversary as a wounded competitor, unable to face competition in the market place and obliged to resort to Justice in order to prevent the "truth" from being brought out into the open. To compound matter further, Les Trois Suisses lodged an appeal, made statements and gave interviews on classic topics such as the virtues of transparency, the defence of consumers' interests and the stifling of innovation. This example demonstrates the contrast between the rhythm of Justice and that of the commercial world leading to an unexpected result. In taking an action against the aggressor, the victim reinforces the effectiveness of its advertising campaign which deliberately violates the law and ensures a complete commercial victory to the author of the aggression. It is probably the reason why this strategy is so common in the distribution sector.[33]

8.3.2.3 Taking Advantage of the Uncertainty of Justice

In theory, Justice is applied uniformly throughout France. All legal institutions operate to this end. Statute law guarantees the uniformity of the rules and the Supreme Court of Appeal guarantees the uniformity of jurisprudence. Normally, in the same circumstances, the same rule applies in the same way whatever the

[32]T. Come, *Les stratégies juridiques des entreprises*, Vuibert ed. (Entreprendre, 1998).

[33]For example see, P. Bouzat, Note sous TGI Paris 1° Civ. (8 janvier 1992), Leclerc, Revue Trimestrielle Droit Commercial, 495.

parties, the judge, the place or the time of the judgment. However, even if authorities strive to standardise judicial decisions, they can not rule out a certain amount of variability in the decisions. Indeed, in some cases, contradictory judgments will occur. According to public opinion, Justice is not free from risks. The polls show that French people are aware of these hazards.

For a few years, powerful parties have developed strategies aimed at using Justice as a tool for managerial or commercial purposes. A commercial litigant can thus endeavour to initiate favourable legal action. Lawsuits can be instituted to test the reactions of judges to new commercial processes or innovative contractual clauses which appear to challenge legal or regulatory provisions, i.e. test cases. A company may also go to different courts in order to obtain favourable decisions related to a specific point. With a bit of luck and skill, the stakeholders, i.e. customers, competitors, partners, etc., will consider these decisions or "judge-made law" and ultimately take this case law or "matter of principle" actions for granted.

These strategies require funds and patience. Therefore, it is necessary to bring cases to courts when favourable circumstances arise, not when it is known in advance that the case will be lost. These strategies also require technical means such as a team of lawyers dedicated to the implementation of the strategy and the finances to support them. The legal team is devoted to initiation of procedures, each time trying new arguments, producing the pages of legal doctrine, etc., until the team obtains a succession of decisions more or less favourable to the corporate client's point of view. These decisions are published and widely annotated in law reviews, giving the impression that Justice eventually recognises the merits of the company. This kind of strategy occurs in the sector of selective distribution. One remembers the battle carried out by car producers in order to generate a decision that refused any compensation for their agents in the event of a non-renewal of the concession at the end of the contractual period.[34]

One could say that these strategies cannot really be effective in a country where statute law is so firmly rooted. The fact that they are frequently implemented demonstrates that the barriers between statute law and common law are undoubtedly lower than is often said.

8.4 Conclusion

The poor image of Justice is not without consequence on the actions of business people and corporate strategies. These strategies vary widely. Some strategies are obvious, for example, prioritising out-of-court settlements to avoid the slowness,

[34]D. Ferrier, Note sous Cass. com. (9 décembre 1988) (Dalloz), Somm. 19; See also B. Bouloc, Note sous Cass. com. (6 janvier 1987) Revue Trimestrielle de Droit Commercial 122; See also M. Virassamy, Note sous Cass. com. (4 janvier 1994) (Dalloz, 1995) 355; See also L. Malaurie-Vignal, Note sous Cass. com. (9 avril 2002) 2003 Contrat Concurrence Consommation no. 9.

cost and the hazards of going to law. Other strategies are much more subtle and manipulative, such as those that seek advantage in actual or perceived defects in Justice to deter the opposing party from asserting its rights. In this regard, judges should pay attention to the action whose genuine goal lies in using public judges and procedures as tools that can be diverted from their natural purpose in order to require a substantial advantage over other competitors.

Part II
Legal Strategies In Action

Chapter 9
Perspectives on Legal Strategy through Alternative Dispute Resolution

Mary J. Shariff, Marlene Pomrenke and Vivian Hilder

Abstract In this chapter, legal strategies are discussed in the context of Alternative Dispute Resolution (ADR), primarily from a Canadian perspective. When ADR was established as an alternative to the traditional and often unsatisfactory dispute resolution regime, i.e. litigation, the element of *choice* was introduced causing ADR to be recognised by legal and business communities alike as a powerful tool in the formation of strategic resolutions to a client's given dispute. Early strategies included the ability to avoid, manipulate or even block aspects of the traditional litigation process.

Recently, many ADR legal strategies have become more sophisticated and in turn, appear more elusive, as strategists become aware of the regulatory and public response to previously deployed strategies. Accordingly, by reference to specific examples, the authors present a novel typology of ADR legal strategies by classifying strategies on the basis of their increasing levels of sophistication, with particular emphasis on arbitration. This typology classifies strategies as they move from opportunities implicit in the ability to choose between legal processes (*cataloguing*; *positioning*; *oppositioning*) to opportunities illuminated by legislative or judicial response to other strategies once implemented (*flipping*) to the assumption of ADR culture into corporate practice to the exclusion of traditional legal players (*appropriation*).

The authors place ADR legal strategies into such a typology for the purposes of discussion and analysis. They conclude that strategy "captures the reality" of the ADR regime – that is, for many disputants it may not be as much about transforming conflict as it is about appropriating the process for its own objectives.

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9.1 Introduction

> ADR, in a sense, encompasses any lawful means of dispute resolution other than litigation. In fact, it is a wide variety of procedures reaching from the lawyer's most basic everyday task of negotiation to the courthouse steps. Just as great artists employ a number of media to achieve their desired artistic goals, lawyers most cognizant of their clients' best interests stand ready to pursue any of numerous possible paths to their client's goals, depending on which is the most promising in any particular situation.[1]

The above quote captures what the legal and business communities quickly realised about Alternative Dispute Resolution (or ADR) once it began to receive broad acceptance as a viable alternative to public judicially-based litigation – there was far more to be gained by using the ADR process as part of a deliberate legal strategy.[2] Indeed, because ADR was introduced as an alternative to the traditional litigation system, it created choice. With choice, these communities recognised that ADR was poised to be both a powerful tool in the formation of strategic resolutions to a client's given dispute and a mechanism that could be used to avoid, manipulate or even block aspects of the traditional litigation process to the client's best advantage.

Creative use of ADR as part of a legal strategy arsenal continues despite ongoing regulatory efforts to curb strategies which have been perceived by courts and legislators as offensive. Firms both respond to, and rely on, the regulatory regime of the day to stimulate the development and implementation of ADR legal strategies that benefit the client. The strategic use of ADR can range from the procedural, such as the tactical use of delay, to the more pre-emptive, as in the prevention of class action suits through cleverly deployed arbitration clauses. Therefore because ADR, even in its simplest forms, bolsters the ability to control both the legal process and outcome of a dispute, it is ripe for the ongoing development of legal strategy based on the perception that the rule of law can be manipulated and even defeated in a manner that will avoid penalty.[3]

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[1] L. J. Lott, "Alternative Frameworks for Dispute Resolution" (2002), online: Lott & Friedland Intellectual Property http://www.lfiplaw.com/articles/adr.htm [Lott].

[2] See discussion on the change in perception of ADR from "alternative dispute resolution" to "appropriate dispute resolution" in R. M. Nelson, *Nelson on ADR* (Thompson Canada Limited, 2003) 1 [Nelson]; See also R. H. McLaren, and J. P. Sanderson, *Innovative Dispute Resolution: The Alternative* (Thompson Carswell, 2008) [McLaren and Sanderson].

[3] L. M. LoPucki, and W. O. Weyrauch, "A Theory of Legal Strategy" 2000 49(6) Duke Law Journal 1411, an edited reprint in this text at Chap. 4 [LoPucki and Weyrauch]. The genesis of this contribution was inspired by the basic idea asserted by LoPucki and Weyauch that: "'Law' has direct effect through the rendition and enforcement of judgments in actual cases and indirect effect through the anticipation of such rendition and enforcement in hypothetical cases". LoPucki and Weyrauch concluded that "within the wide range of what is culturally acceptable in legal outcomes, legal strategies are the primary determinants of who will decide cases, under what constraints, and with what consequences". For fuller discussion as to how legal outcomes are the product of the complex interaction of virtually anything that might persuade decision-makers, see LoPucki and Weyrauch ibid.

The goal of this chapter is to assist in the development of legal strategy theory by identifying different examples of strategy being implemented in the ADR arena, particularly those involving mediation and arbitration.[4] Although it is not possible to present all ADR legal strategies being implemented, this contribution seeks to identify and categorise some of the strategies being advanced in the area of ADR. These strategies are then classified under a novel typology based on their increasing levels of sophistication that become apparent as the strategies move from opportunities implicit in the ability to choose between legal processes to opportunities illuminated by legislative or judicial response to other strategies once implemented. Such classification or typology should also assist in advancing a definition of legal strategy by deepening the understanding of the connections between ADR processes, practices and players.

Accordingly, this contribution identifies examples of the strategic use of ADR (and regulatory responses where applicable) at three separate levels or orders, namely:

1. First order or traditional legal strategies/quasi-strategies that arise out of the existence of choice between different dispute resolution processes, including litigation, and the ability to select or manoeuvre between and within these processes
2. Second order or post-regulatory legal strategies generated in response to and/or relying on the knowledge of legislative or judicial responses to previously implemented strategies
3. Third order or cultural legal strategies based on shifts in the property of dispute resolution regimes/processes

This contribution does not presume to provide a concrete or comprehensive definition of legal strategy as it pertains to the use of ADR. Rather, it is aimed at providing a provocative starting point for opening up the debate and discussion of legal strategy as viewed through the ADR lens. In so doing, the authors hope that this contribution will assist in the understanding of how ADR has been used as a legal strategy thus far and how it might be positioned for similar use in the future.

[4]It is not possible, nor is it the goal of this contribution to give a full account of all elements and processes in the ADR continuum. The focus of the chapter is on legal strategies in arbitration and commercial contracts mainly from a Canadian/North American experience and perspective and seeks to identify, clarify and classify legal strategies in the field of ADR (primarily arbitration) that the authors have observed in operation in North America. For a detailed description of ADR, see for example, McLaren and Sanderson (n 2); See also A. Redfern, and M. Hunter, *Law and Practice of International Commercial Arbitration* 4th ed. (Sweet & Maxwell, 2004) [Redfern and Hunter].

9.2 Setting the Strategic Stage: ADR, an Alternative to Judicially-Based Litigation

Alternative dispute resolution is said to have early "intellectual founders"[5] and the principles have been "drawn from many different fields".[6] In this chapter we primarily use the term to refer to the alternative processes developed chiefly to address some perceived shortcomings of the traditional adversarial litigation system such as the alienation of the disputant from the dispute as it is transformed into legal jargon; the disputant's loss of control of the resolution process; the barring of the disputant from assisting with the crafting of a solution; the slow moving and high cost of the litigation process; and the polarising and often dissatisfying winner–loser result.[7]

ADR has been said to be the expression of the desire to allow the disputants maximum participation and control in the resolution of their dispute.[8] From a non-strategist point of view the particular method of dispute resolution chosen has typically depended *inter alia* on factors such as the nature of the conflict, the potential cost of litigation, the cultural context of the conflict, the philosophical stance of the lawyers, the level of conflict between the participants or litigants and the way in which the particular judicial system at issue understands and approaches the varied ADR processes. The mere consideration of such objectives/factors cannot be said to have been a challenge to the rule of law. However, once counsel fully embraced ADR as a faster route to more efficiently and effectively respond to clients' multi-faceted needs and wants,[9] the concepts of ADR were infused with creative options, removing the label as "litigation for wimps"[10] and replacing it with strategy, at least for those with vision. Hence, over the past three decades, the continuum of ADR methods has expanded, becoming more complex and specialised with the range of dispute processes being "only limited by our imagination".[11]

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[5]C. Menkel-Meadow, "Mothers and Fathers of Invention: The Intellectual Founders of ADR" (2000–2001) 16 Ohio State Disp. Res. Journal 1.

[6]Ibid 3–5.

[7]See discussion in C. Menkel-Meadow, "Introduction: What Will We Do When Adjudication Ends? A Brief Intellectual History of ADR" (1997) 4 UCLA L Rev. 1613; See also J. M. Barkett, "Tipping the Scales of Justice: The Rise of ADR" (2008) 22(4) Natural Resources and Environment 40 [Barkett]; See also McLaren and Sanderson (n 2) 1.2.

[8]McLaren and Sanderson, ibid 1.2.

[9]See discussion in C. Honeyman, and A. K. Schneider, A, "Catching Up with the Major General: The Need for A 'Canon of Negotiation'" (2004) 87(4) Marquette Law Review 640.

[10]See S. Gordon, "Five for the Future" (2006) 15(6) National, Canadian Bar Association 45; See also discussion on litigator personality in C. Yablon, "Stupid Lawyer Tricks: An Essay on Discovery Abuse" (1996) 96(6) Columbia Law Review 1638–1639.

[11]J. MacFarlane, *Dispute Resolution: Readings and Case Studies* 2nd ed. (Emond Montgomery Publications Ltd., 2003) 104 [MacFarlane].

ADR methods range from fully private, non-formal consensual models to more formal mandated court-annexed models. Within this continuum there are many methods of dispute resolution including most typically: early neutral evaluation, negotiation, conciliation, facilitation, mediation and arbitration. This discussion focuses on the legal strategies used by commercial and business disputants. Accordingly, our examples are drawn from mediation and arbitration, the most widely practised ADR forms[12] and the forms with which the corporate community is most familiar.[13] At the risk of being over-simplistic, mediation and arbitration can be defined briefly as follows:

- Mediation is an assisted form of negotiation in which a neutral third party, the mediator, assists the parties in negotiating with each other in an attempt to arrive at a consensual resolution.
- Arbitration is a model that is closer to traditional litigation. It involves a more formal presentation by each of the disputants who present their respective arguments and proof, often on a best document basis, to a third party neutral who has the power to deliver a final binding decision.

Additional methods of ADR other than mediation and arbitration may provide more effective mechanisms to achieve resolution in a given situation. However, as noted above, we have chosen to present examples of legal strategies related only to mediation and arbitration due to their more frequent usage and higher profile.

The following section classifies the ways in which ADR may be used as a legal strategy.

9.3 Three Orders or Levels of ADR Strategy

9.3.1 First Order/Traditional Strategies or "The Muscle in Choice"

Integrate your best attacks to unbalance your competition.
Mark McNeilly, Sun Tzu and the Art of Business, 2000

In the commercial community, and others, ADR was originally welcomed as a more effective way of resolving disputes than the traditional litigation system that was slow and expensive. Specifically, it was perceived as a way of wresting control from the courts and hopefully thereby avoiding unreasonable outcomes and the penalising

[12]See generally, Law Society of British Columbia, "Lawyers as Dispute Resolution Professionals: A Discussion Paper" (4 May 2007) 7 fn 2; See also D. B. Lipsky, and R. L. Seeber, "In Search of Control: The Corporate Embrace of ADR" (1998) 1 U. Pa. J. Lab. & Emp. L. 137 [Lipsky and Seeber, *In Search*].

[13]Ibid.

effects of costly litigation. It was not long however before the business world quickly appreciated the power inherent in being able to choose between the two alternative regimes.

As expertise in the field of ADR developed, the increasingly strategic use of ADR emerged as there was a deepening appreciation of choice-related strategies along with an increased ability to identify the method that would be most helpful to the disputant. Further, commercial disputants realised that the use of an ADR process instead of traditional court process would not require significant changes to the structure or conduct of the company, although there was recognition that access to expertise in the ADR field might require a shifting or mobilization of corporate resources, particularly if the legal team previously used by the company was smaller or not well-versed in both regimes.[14]

Notwithstanding potential limitations of resource availability, the ability to seek resolution through an avenue other than the traditional court process allows a party to strategically place itself in a position where it can avoid aspects of the traditional process that may not be in its favour yet still obtain a court-enforceable result.[15] Similarly, expert facility with the different dispute regimes illuminates more complex strategies aimed at playing one regime off the other to the party's best advantage.

Accordingly, the ability to choose between two regimes or processes leads to first order legal strategies which we can describe as:

- *Cataloguing*: The tracking and taking of benefits arising from the ability to circumvent or select one process over another;
- *Positioning*: The manipulation of a first process to gain advantage in a second process; and
- *Oppositioning*: The pitting of one process against another process for tactical advantage.

[14]See for example discussion on cost–benefit analysis of the effectiveness of existing resolution processes in M. T. Reilly, and D. L. MacKenzie, *ADR in the Corporate Environment* (CCH Canadian Ltd., 1999) 38 [Reilly and MacKenzie].

[15]For example, with respect to international commercial arbitrations, the 1958 *Convention on the Recognition and Enforcement of Foreign Arbitral Awards* [the "New York Convention"] is considered the foundation instrument of international arbitration. It requires courts of contracting States to give effect to an agreement to arbitrate when seized of an action in a matter covered by an arbitration agreement and, subject to certain exceptions, also requires courts to recognise and enforce awards made in other States. It entered into force on 7 June 1959 and has been signed by over 160 countries. United Nations Commission on International Trade Law, online: 1958 – Convention http://www.uncitral.org/uncitral/en/uncitral_texts/arbitration/NYConvention.html. Additionally, the *UNCITRAL Model Law on International Commercial Arbitration* reflects worldwide consensus on key aspects of international arbitration practice including the recognition and enforcement of the arbitral award having been enacted by States of all regions and the different legal or economic systems of the world [the Model Law]. For further information see online: 1985 – UNCITRAL Model Law http://www.uncitral.org/uncitral/en/uncitral_texts/arbitration/1985Model_arbitration.html; See also discussion in C. Cronin-Harris "Mainstreaming: Systematizing Corporate Use of ADR", 59 Albany Law Review 847 (1995–1996) 13–14.

9.3.1.1 Cataloguing

Cataloguing can perhaps be viewed as the most primitive of legal strategies or as a quasi-strategy. It simply involves an amassing of knowledge of the advantages and disadvantages associated with each respective system, creating a list of benefits and drawbacks. When a particular result is desired by the disputant, or conversely and perhaps more significantly, sought to be avoided, the catalogue can be canvassed so as to achieve, or avoid, that result by a strategic choice of system.

Examples of cataloguing in the realm of ADR are abundant. Indeed, volumes have been written on the advantages and disadvantages of ADR processes like arbitration and mediation over the traditional court system.[16] Some of the most obvious examples include:

(a) Mediation and arbitration are private ADR processes. Details of the dispute and any settlements reached remain in the private realm. This is considered a very positive feature for businesses concerned about negative publicity; when the subject matter may be considered controversial; or for example, when intellectual property is at the heart of the dispute.[17]
(b) ADR process can avoid the full impact of common law legal doctrines like *stare decisis* and precedent otherwise applicable in common law courts.[18]
(c) Relaxed rules of evidence like the parole evidence rule. This is particularly helpful in arbitration when a business wishes to rely on evidence that would typically not be allowed by the courts.[19]

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[16]See for example J. W. Cooley, *Mediation Advocacy*, 2nd ed. (NITA, 2002) Chap. 1, for charts identifying the differences between processes; See also general discussion in A. Kupfer Schneider, "Building a Pedagogy of Problem-Solving: Learning to Choose Among ADR Processes" (2000) 5 Harv. Negot. L. Rev. 113 [Schneider]; See also S. A. Weiss, "ADR: A Litigator's Perspective" (1999) 8(4) Business Law Today 30; See also McLaren and Sanderson (n 2) 1.1–1.6 and 5.1; See also Reilly and MacKenzie (n 14); See also The Honourable G. W. Adams, Q.C., *Mediating Justice: Legal Dispute Negotiations* (CCH Canadian Limited, 2003) 155, 319; See also C. A. McEwen, and R. J. Maiman, "Small Claims Mediation in Maine: An Empirical Assessment" (1981) 33 Me. L. Rev. 237 comparing mediated small claims court cases to adjudicated small claims court cases for levels of satisfaction and sense of fairness; See also D. L. Marston, "Project Based Dispute Resolution: ADR Momentum Increases into the Millennium" (2000) 48 C.L.R. (2d) 221 comparing ADR systems to litigation in construction disputes; See also D. A. Fromm, "An Introduction to ADR for Real Estate Practitioners" (1996) 49 R.P.R. (2D) 223 for charts identifying the differences between processes; See also G. Walker, "Bank Recovery – The Development of Judicial and Arbitral Redress Under English Law" (1999–2000) 15 BFLR-CAN 369; See also G. W. J. Ghikas, Q.C. "Why Americans Should Arbitrate in Canada" (2007) Bordner Ladner Gervais, LLP, online: Mondaq, Litigation and Arbitration http://www.mondaq.com/article.asp?articleid=55566 [Ghikas]; See also discussion in L. Riskin, "Decision Making in Mediation: The New Old Grid and the New Grid System" (2003) 79(1) Notre Dame Review 5.

[17]For example see discussion in E. A. Dauer, "Confidentiality in ADR", Erika S. Fine, ed., *Containing Legal Costs* (Butterworth Legal Publishers, 1988) 17.

[18]For example see L. Boulle, "Mediation, Justice and the Legal System", *Mediation: Principles Process Practice*, 2nd ed. (LexisNexis Butterworths, 2005) Chap. 5 [Boulle].

[19]Ibid.

(d) Disputants may have the ability to influence the outcome by influencing the selection of the third party neutral. Dependent on how a party arrives at the arbitration process, for example, it is possible to encourage or influence the selection of an arbitrator(s) who will be more amenable to the desired result.[20]

The list of these types of considerations goes on and on. The key point here however, is not the substance of the list per se, but the creation and existence of the list or catalogue itself in that this type of legal strategy permits an increased opportunity to control the legal outcome through access to a compilation or shopping list of elements. Arguably, using a *cataloguing* strategy is not a simple yielding to the rule of law as it can be seen as a challenge to the omnipotence and rules of lawmakers. To be sure, cataloguing is somewhat more sophisticated and a step beyond the mere seeking of advantage under the rules.

9.3.1.2 Positioning

A good example of positioning can be observed in the early attempts by disputants to exploit the mediation process to obtain confidential information.[21] Although the mediation process can now be generally said to be confidential, it was not originally protected as such by law in many jurisdictions.[22] Consequently, in early mediations, a party not *bona fide* engaged in the mediation process, could, *inter alia*, press for admissions and other information, whether oral or documentary, with the potential consequence that that information might be used for decision making in a later arbitration or court process.[23]

[20]For example, see generally O. Ashenfelter, "Arbitrator Behavior" (1987) 77(2) The American Economic Review (Papers and Proceedings of the Ninety-Ninth Annual Meeting of the American Economic Association) 342; See also J. Rezler, and D. J. Petersen "Strategies of Arbitrator Selection" 70 Labor Arbitration Reports 1308; See also N. E. Nelson, and S. Min Kim, "A Model of Arbitral Decision Making: Facts, Weights, and Decision Elements" (2008) 47(2) Industrial Relations: A Journal of Economy and Society 266; See also D. E. Bloom, and C. L. Cavanagh "An Analysis of the Selection of Arbitrators" (1986) 76(3) The American Economic Review 408; Similarly, disputants may have ability to influence outcome by selecting an arbitral forum more beneficial to the disputant. See for example, discussion in Ghikas (n 16).

[21]See discussion in Manitoba Law Reform Commission, *Confidentiality of Mediation Proceedings*, Report #94 (1996) Chaps. 1 and 3 [Manitoba Law Reform Report]; See also O. V. Grey, "Protecting the Confidentiality of Communications in Mediation" (1998) 36 Osgoode Hall L. J. 667 [Grey]; See also discussion in Nelson (n 2) 138.

[22]Ibid.

[23]Ibid; See also Manitoba Law Reform Report (n 21); The instrumental use of mediation as an early and inexpensive discovery process has also been described by commentators as a "rejection" of mediation. See M. Keet, *Evolution of Lawyers' Roles in Mandatory Mediation: A Condition of Systemic Transformation* 68 Sask. L. Rev. 313; For a discussion on the manipulation of confidentiality and the arbitral process see Barkett (n 7) 43; See also Redfern and Hunter (n 4) 1–53.

It is important to note here that this particular strategy, because of its clearly abusive nature and its hampering of the public policy goal of encouraging settlement discussions,[24] did not go unnoticed with the result that it has been greatly constrained by statutory enactment,[25] court judgment,[26] or institutional practice rules[27] that may govern the mediation dependent on the jurisdiction at issue and party selection.

9.3.1.3 Oppositioning

An example of the legal strategy of oppositioning or the pitting of one regime against the other is or was the use of the court process to delay or obstruct the dispute resolution process.[28] Similar to the litigation tactic of using protracted discovery proceedings to wear opponents down, confuse, delay and increase expense,[29] a disputant engaged in an arbitration process, for example, could invoke court process on a number of matters still considered to be in the court's

[24]See Grey (n 21) 677; D. Vaver, "Without Prejudice Communications – Their Admissibility and Effect" (1974) 9 U.B.C.L. Rev. 85, 94; See also J. W. Hamilton, "Protecting Confidentiality in Mandatory Mediation: Lessons from Ontario and Saskatchewan" (1999) 24 Queen's L. J. 574; See also generally the concurring judgment of Supreme Court of Canada Madame Justice Abella then of the Ontario Court of Appeal in *Rogacki v. Belz*, (2003) 67 O.R. (3d) 330, (2003), 232 D.L.R. (4th) 523, 177 O.A.C. 133, 2003 CanLII 12584 (ON C.A.), online: Canadian Legal Information Institute http://www.canlii.org/en/on/onca/doc/2003/2003canlii12584/2003canlii12584.html [*Rogacki v. Belz*].

[25]For example, a number of American states have enacted legislation to protect mediation confidentiality as modeled under the American Bar Association's, *Uniform Mediation Act,* including the District of Columbia, Illinois, Iowa, Nebraska, New Jersey, Ohio, South Dakota, Utah, Vermont and Washington.

[26]*Rogacki v. Belz* (n 24); See also *Chocoladenfabriken Lindt v. Nestle* [1978] RPC 287; But also note the "unambiguous impropriety" exception. See *Savings and Investment Bank Ltd. v. Fincken* [2003] EWCA Civ. 1630, 14 November 2003; For further discussion on American position on confidentiality in mediation see generally C. H. Macturk, "Confidentiality in Mediation: The Best Protection Has Exceptions" (1995) 19 Am. J. Trial Advoc. 411.

[27]For example see American Arbitration Association, Procedure M-10 of the Commercial Arbitration Rules and Mediation Amended and Effective September 1, 2007, online: American Arbitration Association, Dispute Resolution Services Worldwide http://www.adr.org/sp.asp?id=22440%20#M-10; See also discussion in Boulle (n 18) Chap. 13, "Training, Accreditation and Codes of Conduct in Mediation"; See also Macfarlane (n 11); See also discussion in J. Manwaring, "Legal Issues", Julie MacFarlane, *Dispute Resolution: Readings and Case Studies* 2nd ed. (Emond Montgomery Publications Ltd., 2003) 512.

[28]For an example of what might be considered an "oppositioning" strategy related to the timing of mediation to impede the process of resolution see discussion in L. Crush, "The State of Child Protection Mediation in Canada" (1996) 42 C.F.L.Q 191.

[29]See W. I. Lundquist, "The Trial Lawyer or Litigator", J. G. Koeltl ed., *The Litigation Manual* (American Bar Association, 1989) 181.

jurisdiction.[30] This might include challenging the appointment, jurisdiction or competence of the arbitrator or tribunal, or indeed challenging the validity or operation of the ADR agreement itself. As widespread abuse began to decrease the attractiveness of the arbitration process, the demand from the international business community for a legal regime to control it increased.[31] One result was the adoption by many states of the UNCITRAL Model Law on International Commercial Arbitration[32] which *inter alia* contains explicit rules with respect to the extent and timing of court intervention. As an example, Article 5 of the Model Law sets out that no court shall intervene except where so provided in the Model Law. Further, where the Model Law allows for court involvement on certain matters (for example to challenge the arbitrator[33] or competence of the tribunal[34]) it also provides that while the request to court is pending, the tribunal may continue with the arbitral process.

This statutory integration/harmonisation of the two regimes of court and arbitration has been accompanied by an increasing deference, and indeed, encouragement by the courts to support the ADR process, when it has been selected by the parties as the process by which any future disputes between them are to be resolved.[35]

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[30]See for example *PetroKazakhstan Inc. v. Lukoil Overseas Kumkol BV* (2005) 144 ACWS (3d) 65 (Alta Q.B.); *Grammercy Ltd. v. Dynamic Tire Corp.* (2004) 71 OR (3d) 191 (SCJ); *CanWest Global Communications Corp. v. Hollinger Inc.* 2004 CarswellOnt 3291; See also discussion on strategic stay applications in W. G. Horton, "Canadian Arbitration Jurisdprudence: An Update" (2006) 11(2) Arbitration Newsletter: International Bar Association Legal Practice Division 8.

[31]For example, English arbitration was largely reformed by the *English Arbitration Act* 1996 because of court intervention in English arbitrations. See discussion in J. D. M. Lew, L. A. Mistelis, and S. Kröll, *Comparative International Commercial Arbitration* (Kluwer Law International, 2003) 356–358.

[32]The Model Law (n 15). Legislation based on the Model Law has been enacted in more than 55 states including: Australia, certain provinces in Canada, Germany, Great Britain, Greece, India, Iran, Ireland, Mexico, New Zealand, Northern Ireland, Spain, Scotland, and certain states in the United States of America.

[33]Model Law (n 15) Article 13.

[34]Ibid Article 16.

[35]In the UK see for example, *Premium Nafta Products Limited (20th Defendant) and others (Respondents) v. Fili Shipping Company Limited (14th Claimant) and others (Appellants)* [2007] UKHL 40 para. 26 per Lord Hope of Craighead: "The proposition that any jurisdiction or arbitration clause in an international commercial contract should be liberally construed promotes legal certainty. It serves to underline the golden rule that if the parties wish to have issues as to the validity of their contracts decided by one Tribunal and issues as to its meaning or performance decided by another, they must say so expressly. Otherwise they will be taken to have agreed on a single Tribunal for the resolution of all such disputes"; See also for example, *Leicester Circuits Limited v. Coates Brothers Plc.* [2003] EWCA Civ. 333 5 March 2003 where UK court penalised applicant for costs for withdrawing from agreed mediation at the last minute; See also *Cable & Wireless v. IBM United Kingdom Ltd.* [2002] EWHC 2059 (Comm. Ct.) where an escalation clause requiring mediation before litigation is enforceable in English law; In Canada see also *Dell Computer Corp. v. Union des Consommateurs et al* 2007 SCC 34 and *Rogers Wireless Inc. v. Muroff* 2007 SCC 35 where the Supreme Court of Canada put the contract for arbitration ahead of public policy considerations for supporting class action proceedings. See

An earlier, yet similar integration/harmonisation can also be observed in the almost universal adoption of the Convention on the Recognition and Enforcement of Foreign Arbitral Awards or New York Convention[36] which also facilitates the enforceability of arbitral awards from one state to another. Such integration of parallel or alternate regimes re-introduces the rule of law and consequently stifles legal strategy.

In addition to increasing integration/harmonisation, it also appears that these first order ADR legal strategies are fairly transparent thus rendering them more vulnerable to regulatory attack when they come into conflict with public policy goals. For example, there has been an ever expanding movement towards public access and disclosure of private settlements, particularly in the areas of public health and safety, hazards, and public officials or bodies.[37] Consequently an increasing number of states are passing laws to that end, requiring disclosure of settlements or revising procedural rules to modify common confidentiality practices.[38]

Historically, it can be said that a rivalry existed, each with its own dedicated proponents, between the two camps, i.e. litigation and privatised decision-making, at times including open conflict.[39] Perhaps it can now be observed that the increasing recognition of alternate methods of dispute resolution as compatible with the role of the court and the increasing support given by the court to the private dispute resolution process is attributable, at least in part, to

below part III(B); See also *Onex Bell v. Ball Corp.* (1994), 12 B.L.R. (2d) 151 (Ont. Gen. Div.) where a Canadian court referred a dispute to arbitration despite the dispute between the parties that the remedy of rectification may not be one in which an arbitral tribunal was capable of granting; See also *Canadian National Railway Co. v. Lovat Tunnel Equipment Inc.* (1999), 174 D.L.R. (4th) 385 (Ont. C.A.) where the Ontario Court of Appeal stayed an action on the basis that the words "may refer any dispute. . ." meant that either party could refer the dispute to arbitration, and once referred, the arbitration was mandatory; In the United States, see also *Gilmer v. Interstate / Johnson Lane Corp.* 500 U.S. 20 (1991) and discussion in M. H. LeRoy & P. Feuille, "Happily Never After: When Final and Binding Arbitration Has No Fairy Tale Ending" (2008)13 Harvard Negot. Law Rev. 167.

[36]The New York Convention (n 15).

[37]See C. Menkel-Meadow "Public Access to Private Settlements", *What's Fair*, *Ethics for Negotiators* (John Wiley & Sons, Inc., 2004) 507–512.

[38]Ibid.

[39]See description of tension between courts and arbitrators as "trade rivals in the dispute resolution business" in The Honourable J. J. Spigleman AC, Chief Justice of New South Wales (10 August 2007) Address to the Joint Conference of ACICA and ACLA, 3, online: Supreme Court New South Wales, http://www.lawlink.nsw.gov.au/lawlink/Supreme_Court/ll_sc.nsf/pages/SCO_spigelman100807 [The Honourable J.J. Spigleman AC]; See also discussion in J. Uff QC, "Dispute Resolution in the 21st Century: Barriers or Bridges?" (February 2001) 67 Arbitration 4 (Chartered Institute of Arbitrators' Conference, Dublin, 2001) 4.

the evolution of legal strategies seeking to find advantage in non-integrated or non-harmonised regimes.[40]

9.3.2 *Second Order/Post-regulatory Response Strategies or "The Power in Predictability"*

The art of victory is learned in defeat.
Simón Bolivar (1783–1830)

As the nuances of the ADR battlefield become better understood due to increasing institutionalisation, statutory apparatus and court interpretation, there arises additional fodder for the development of a second order of ADR legal strategy, i.e. predictability.

Knowledge of contemporary legal positions or responses to strategies previously deployed provides a platform of predictability which can be used to manipulate the dispute resolution process for future anticipated disputes. In turn, this increases the possibility of arriving at specific desired outcomes.[41] This kind of knowledge-based pre-emptive legal strategy can be observed in the insurance industry practice of fine-tuning specific exclusion or limitation of liability clauses after a court interpretation unfavourable to the industry has come down.[42]

Examples of similar strategies in the realm of ADR are also emerging. In particular, there have been a number of recent North American examples involving the imposition of mandatory arbitration clauses by retailers and service providers in their consumer contracts. These mandatory clauses are usually incorporated as part of a standard form contract, which under most circumstances, the consumer is not able to negotiate or alter.

While the apparent objectives behind the utilisation of such clauses at first appears acceptable, i.e. to avoid the costs of litigation and potential negative

[40]For further discussion and additional ways to perceive optimisation strategies that arise from choice, contradictions and legal pluralism, see A. Masson, "The Origin of Legal Opportunities" (2009) 2.2, Chap. 3 of this text [Masson].

[41]" 'Law' has direct effect through the rendition and enforcement of judgments in actual cases and indirect effect through the anticipation of such rendition and enforcement in hypothetical cases . . . The legal strategist manipulates those odds in a game of skill, expanding and developing an array of decisions, issues, and problems in a manner calculated to confuse and ultimately overwhelm the opponent". LoPucki and Weyrauch (n 3) 1412.

[42]See generally discussion in R. Lawson, *Exclusion Clauses and Unfair Contract Terms*, 8th ed. (Sweet & Maxwell, 2005) Chaps. 1 and 2; See also E. J. Zulkey, *Litigating Insurance Disputes* (Juris Publishing, 2008); See also D. McGarvey, and J. Wong " 'Insured v. Insured' Exclusion Clauses Exemplify Importance of Good Drafting" (The Lawyers Weekly, 2006).

publicity,[43] the realisation of the strategy has revealed a much more controversial aim, the ability to impede the right of consumers to access class action proceedings.

In the Quebec, Canada case of *Dell Computer Corp. v. Union des Consommateurs et al*,[44] an individual sought to hold Dell to an advertised low price for a computer product he had purchased over the Internet through Dell's website. The Dell company had its Canadian head office in Toronto and a place of business in Montreal. When Dell refused to honour the advertised price on the basis of a pricing error, the individual joined with a consumer group to seek permission from the court to bring a class action proceeding on behalf of all consumers who had purchased the same product at the significant time. Dell brought a motion to dismiss the proceeding on the basis of a mandatory arbitration clause. Dell argued that the clause provided for disputes to be exclusively resolved before the National Arbitration Forum located in the United States, and that the clause was properly accessible to purchasers via a link on each of the relevant transaction pages.

In finding that the matter was to be referred to arbitration, the Supreme Court of Canada held *inter alia* that:

- "The neutrality of arbitration as an institution is one of the fundamental characteristics of this alternative dispute resolution mechanism. Unlike the foreign element, which suggests a possible connection with a foreign state, arbitration is an institution without a forum and without a geographic basis . . . "[45] As such, because there was no "relevant foreign element", the clause did not offend Quebec legislation that prohibited waiver of the Quebec courts' jurisdiction and the application of applicable private international law.[46]
- ". . .I would lay down a general rule that in any case involving an arbitration clause, a challenge to the arbitrator's jurisdiction must be resolved first by the arbitrator. A court should depart from the rule of systematic referral to arbitration only if the challenge to the arbitrator's jurisdiction is based solely on a question of law".[47]
- Although the class action is of public interest, it is a procedure, and its purpose is not to create a new right.[48]

Accordingly, despite the arguably non-consensual nature of mandatory and exclusive arbitration clauses inserted post-agreement (consent an essential underpinning of

[43]S. Lott, M. H. Beaulieu, and J. Desforges, *Mandatory Arbitration and Consumer Contracts* (Ottawa: Public Interest Advocacy Centre, 2004) 6 [Lott, Beaulieu and Desforges]; See also McLaren and Sanderson (n 2) 5-18.12 – 5-18.17.

[44]2007 SCC 34 [*Dell Computer*].

[45]Ibid para. 21.

[46]Ibid paras. 3, 12, 56, 94, 194–204.

[47]Ibid para. 84.

[48]Ibid para. 105; For discussion on how class action proceedings may serve more than procedural ends, see Lott, Beaulieu and Desforges (n 43) 33.

the raison d'être for the arbitration regime in the first place),[49] the Supreme Court of Canada followed industry expectation and dismissed the class action in support of the mandatory arbitration clause. In other words, the court's support of the mandatory arbitration clause had the collateral effect of preventing access to the class action.[50] It is worthwhile noting, that because the class action proceeding was precluded, possible recourse to favourable precedent or legislation that might have arisen thereto was also eliminated.

The Quebec legislature did not view the elimination of consumer access to class actions with favour. The Quebec *Consumer Protection Act*[51] was amended to prohibit mandatory arbitration clauses in consumer contracts as well as clauses that prohibit consumers from bringing or joining a class action.[52] Similar jurisprudence in Ontario, Canada[53] prompted the Ontario government to invalidate mandatory arbitration clauses in consumer contracts, again through amendments to its consumer protection legislation.[54] Ontario and Quebec are currently the only provinces in Canada with legislation that specifically address mandatory arbitration clauses in consumer contracts.[55]

As the *Dell Computer* case demonstrates, while a company might not be successful by including a clause directly targeting an undesirable circumstance or position, the strategic selection of a different clause can provide the same result. Further, although regulation can be later brought in to control, restrict or nullify the legal strategy once revealed, this type of strategy has an excellent chance of

[49]See *Dell Computer* (n 44) paras. 94–101 for the Supreme Court's analysis as to how the hyperlink to the arbitration clause was not "external" to the contract within the meaning of the *Civil Code of Québec*.

[50]See also *Rogers Wireless Inc*. v. *Muroff* 2007 SCC 35 which applied the principles set out in *Dell Computer*. Although this case is decided under Quebec Law, because arbitration legislation in all Canadian provinces, including Quebec, is based on the Model Law and reflect the New York Convention, it will still have precedential value across Canada. For further discussion see B. Barin, V. Andrighetti, and E. Ouimet, "Recent Developments in Canadian Arbitration Law", Global Arbitration Review (Law Business Research Limited, 2008) s. 2.

[51]*Consumer Protection Act*, R.S.Q. c. P-40.1.

[52]Ibid s. 11.1.

[53]See cases, *Huras v. Primerica Financial Services Ltd*., (2001), 55 O.R. (3d) 449, (2001), 10 C.C. E.L. (3d) 239, (2001), 148 O.A.C. 396 (Ont. C.A.) and *Kanitz v. Rogers Cable Inc* (2002), 58 O.R. (3d) 299, (2002), 21 B.L.R. (3d) 104 (Ont. S.C.J.) [*Kanitz*]; But see British Columbia case, *MacKinnon v. Instaloans Financial Solution Centres (Kelowna) Ltd.* 2004 BCCA 137 (BCCA) where the Court of Appeal allowed a class proceedings certification hearing to proceed in the face of a mandatory arbitration clause [*MacKinnon*].

[54]*Consumer Protection Act*, 2002, S.O. 2002, c. 30, Sch. A, ss. 7 and 8 [Ontario *Consumer Protection Act, 2002*].

[55]For fuller discussion on the negative impact of mandatory arbitration agreements on Canadian consumers and preliminary discussion on the status of mandatory arbitration agreements in United States, European Union, United Kingdom, France, Australia and New Zealand see generally Lott (n 1); see also R. M. Alderman, "Pre-Dispute Mandatory Arbitration in Consumer Contracts: A Call for Reform" (2002) 5 Journal of Texas Consumer Law 58 [Alderman].

succeeding in the first instance and in some jurisdictions, perhaps long enough to recognise competitive gains.[56]

For example, in the United States, the utilisation of mandatory arbitration clauses in consumer contracts is understood to be much more widespread with such clauses "routinely being part of the contracts of most businesses, ranging from banks, car dealers, credit card companies, manufactured home dealers, builders, and hospitals to exterminating companies".[57] Indeed, the widespread growth of these clauses appears to be attributable in part to the US *Federal Arbitration Act*[58] which does not require that arbitration clauses be signed to be enforceable.[59] Perhaps, not surprisingly, these clauses have also received harsh criticism from

[56]In a case similar to *Dell Computer* (n 44), the Ontario Superior Court had opportunity to consider whether sections 7 and 8 of the Ontario *Consumer Protection Act, 2002* (n 54) which permit consumers to participate in a class action even when the contract contains an arbitration clause (a stay of proceedings in favour of arbitration being required under the Ontario *Arbitration Act, 1991*), could apply retroactively to consumer agreements signed prior to those provisions coming into force. In finding that the issue was a matter of statutory interpretation, Perell J. found the provisions were enacted in response to the *Kanitz* case (n 53) where a class proceeding was stayed in favour of the arbitration agreement in the consumer contract and held that the legislation was to apply retroactively as follows:

> In my opinion, these sections were passed to address the mischief that some – it is not necessary to point a finger at all – suppliers of goods and services were using the device of an arbitration agreement not because they genuinely wished to have an alternative to court proceedings to resolve disputes but rather to *immunize themselves from the seat of justice altogether*. Their eagerness to arbitrate was disingenuous because they knew that just as individual actions by consumers would not be viable, so would individual resort to arbitration not be viable. *A disingenuous willingness to arbitrate was being used to thwart at least two of the purposes to be achieved by a class proceeding; namely, access to justice and behaviour modification*. The obvious purpose of s.7 and s.8 of the Consumer Protection Act, 2002 was to stop this mischief, but this mischief is not stopped if the legislation is not applied retroactively. *Indeed, the mischief is exacerbated by the phenomenon described above of a truncated class in a class action*. A retroactive interpretation efficiently and effectively deals with the mischief that the enactment was meant to stop. [authors' emphasis]

See *Smith v. National Money Mart Co* 2008 CanLII 27479 (Ont. S.C.J.) para. 118, online: CanLII http://www.canlii.com/en/on/onsc/doc/2008/2008canlii27479/2008canlii27479.html. On appeal by Money Mart, the Ontario Court of Appeal did not rule on *inter alia* the retroactivity of the provisions but rather found in favour of the class action based on the doctrine of issue estoppel. See *Smith v. National Money Mart Co*. 2008 CanLii 746 (Ont.C.A.); See also *Mackinnon* (n 53) for a similar decision.

[57]Alderman (n. 55) fn 13.

[58]Title 9 U.S.C. Section 1 et seq.

[59]For further discussion see Lott, Beaulieu and Desforges (n 43) 38–39; See also discussion in J. R. Sternlight, "Consumer Arbitration", *Arbitration Law in America: A Critical Assessment* (Cambridge University Press, 2006) 158 [Sternlight].

American commentators.[60] However, legislation has not been forthcoming[61] currently leaving the US courts to monitor the clauses on a case by case basis.[62]

Using the above example as a lens to examine legal strategy, it can be observed that the fall-out from a first run of strategy, whether in the form of statutory reform or judicial comment, can be recycled to form the basis for a more sophisticated level of strategy, i.e. one that manipulates or flips a newly established legal construct (for example, deference to and enforceability of arbitration clauses) to undermine another legal construct (for example, access to class action proceedings).

This strategy of *flipping*, in this case through pre-emptive drafting,[63] will likely be more valuable to a repeat player who is motivated to optimise results and objectives over the long-term, due to its greater stake in future outcomes. Additionally, the ability to develop and implement sophisticated *flipping* strategies will likely be resource dependent, at least for the company that first introduces it.[64]

Regardless, if the strategy is found to be offensive to public policy, it can be closed down fairly quickly through the passing of appropriate statutory apparatus. In order for a *flipping* strategy to be of value over the long-term it must be able to either withstand public policy scrutiny, as demonstrated by the United States

[60]Alderman (n 55) fn 13; See also Sternlight (n 59) 140–151; Also note however that there is a growing body of US commentary and statistical research that argues arbitration is better for consumers. See for example, Institute of Legal Reform, "Latest Empirical Study Supports Use of Consumer Arbitration" (US Chamber of Commerce, July 15, 2008), online: Institute for Legal Reform http://www.instituteforlegalreform.com/media/pressreleases/20080715.cfm.

[61]Only the state of Alabama has legislation in place outlining that pre-dispute arbitration agreements are unenforceable. Ala. Code 1975 §8-1-41; For fuller discussion see Sternlight (n 59) 157–159; However note that legislation aimed at invalidating arbitration clauses in franchise, employment, auto-purchase and lease and consumer agreements has been introduced in the US House of Representatives. See GovTrack.us. S. 1782 – 110th Congress (2007): Arbitration Fairness Act of 2007, online: GovTrack.us (database of federal legislation) http://www.govtrack.us/congress/bill.xpd?bill=s110-1782.

[62]See discussion in Lott, Beaulieu and Desforges (n 43) 40; See also *Green Tree Financial v. Bazzle* 123 S.Ct. 2402 (US Sup. Ct. 2003); See also Sternlight (n 59) 163–172.

[63]"Well drafted commercial arrangements avoid conflict with regulatory regimes, anticipate and therefore avoid disputes and create structures for dealing with the unknown or the unanticipated". The Honourable J. J. Spigleman AC (n 39) 2; For further discussion on drafting generally see for example, C. J. Menkel-Meadow, L. P. Love, A. K. Schneider, J. R. Sternlight eds. *Dispute Resolution: Beyond the Adversarial Model* (Aspen Publishers, Inc., 2005) 772–776 citing K. M. Scanlon, *Drafter's Deskbook for Dispute Resolution Clauses* (CPR Institute for Dispute Resolution, 2002) 772; T. L. Trantina, "How to Design ADR Clauses that Satisfy Client's Needs and Minimize Litigation Risk" (2001) 5 Alternatives 137 and 145; N. Blacker, "Drafting the Arbitration/ADR Clause: A Checklist for Practitioners" (2000) 46 Prac. Law. 55–58; S. Davis, "The Critical Importance of Carefully Drafting Arbitration Clauses" (2003) 22 ARELJ 161.

[64]Another potential example of *flipping* might be observed in the strategy whereby a disputant, through legal counsel, proposes an ADR process "in order to provide proof to the courts of willingness to compromise or participating in mediation in order to send messages to the opposition". For full discussion see P. Brooker, and A. Lavers, "Mediation Outcomes: Lawyers' Experience with Commercial and Construction Mediation in the United Kingdom" (2005) 5 Pepp. Disp. Resol. L. J. 161.

experience, or be so sophisticated that it is concealed from such scrutiny at the first instance.

Additionally, it should also be noted, that a judicial or statutory blow to a legal strategy can reveal an effective counter-strike for the other side. For example, the battle over the validity of mandatory arbitration clauses in consumer contracts in Canada as described above has in turn been *flipped* such that class proceedings are now viewed as a way to "trump" mandatory arbitration clauses.[65]

9.3.3 *Third Order/Cultural Strategies or "The Command in Continuity"*

Finally, strategy must have continuity. It can't be constantly reinvented.
Michael Porter

For at least two decades now, the foremost reason behind corporate integration of ADR is that ADR will reduce legal costs and delays in the resolution of legal disputes.[66] From the outset ADR has carried with it the sentiment that it "pays off".[67]

This strategy of incorporating ADR to improve the "bottom line" is arguably not a true legal strategy because it does not comment on the role and function of the law. Further, the mere characterisation of a dispute as "legal" defies legal strategy as it appears to simply accept that the law is an essential aspect of the business environment. To be a true legal strategy the ADR process must be used in a way which rejects the assumption that law is a necessary facet of the commercial or economic environment.[68] As described earlier, legal strategies are created to overcome the law and strategically manipulate its rules.[69]

Historically it can be observed that decision making involving the incorporation of ADR into corporate process was either *ad hoc* mediation or mandated arbitration triggered by contractual requirements.[70] Hence, recourse to ADR processes originally lacked the cohesiveness of true legal strategy.

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[65]See for example, D. T. Neave, and J. M. Spencer, "Class Proceedings: the New Way to Trump Mandatory Arbitration Clauses? (Ontario, Canada)" (2005) 63(4) The Advocate 495; For further discussion on strategies "fond of reverse causality" see S. Woog, *La Stratégie du Créancier* (Paris: Dalloz, 1997).

[66]D. B. Lipsky, and R. L. Seeber, "Top General Counsels Support ADR: Fortune 1000 Lawyers Comment on its Status and Future" 8(4) American Bar Association: Business Law Today 26 [Lipsky and Seeber, *Top General Counsels*].

[67]Ibid.

[68]LoPucki and Weyrauch (n 3).

[69]Ibid.

[70]Lipsky and Seeber, *Top General Counsels* (n 66) 27.

Additionally, while the 1990s saw the "explosive growth" of ADR, there still existed a reservation to fully incorporate ADR due to a lack of understanding of, *inter alia*, the role of neutrals, the role of lawyers, the processes themselves and their limits.[71] To some, ADR was even perceived as "faddish" and to be viewed with caution so that due process and other critical safeguards might not be sacrificed.[72] Clearly, although certain tactical strategies within and between ADR processes were being deployed, ADR as a legal strategy within a broader strategic context had not yet fully emerged. ADR was still largely perceived as a tool in the lawyer's toolbox with legal counsel typically at the helm of the dispute.

Today, the role of ADR is undergoing a significant evolution. It is rapidly becoming more than a simple tool or alternative to litigation. It is being established as a distinct corporate culture.[73] For example, a recent study by Herbert Smith LLP in association with Gleiss Lutz and Stibbe (The Herbert Smith Report) examined how 21 of the United Kingdom's blue-chip companies were currently using ADR. The Herbert Smith Report found that the corporations took four distinct approaches in their attitudes to and use of ADR. The fourth group, called the "Embedded Users", ensured that disputes were being managed in a systematic and consistent way with ADR playing a central role in the culture of those organizations. By embedding the ADR culture into their corporate management procedures, "they [not only] achieved greater savings in external legal costs and in management time spent on dispute resolution . . . [but they took] positive steps to align the approach of their external dispute resolution lawyers on ADR with their own views".[74]

"Embedded users" are using ADR as a legal strategy to create their own solutions, effectively "depriving judges of any control".[75] Operating unseen and unmonitored by government and/or courts, the embedded ADR effectively is its own regime. Here we see a "sequence of practices in which base values are utilised to influence outcomes and effects".[76] Hence, the absorption of ADR as a culture by the business community indicates an increase in the chance of a company's

[71]Ibid 28.

[72]Ibid.

[73]Herbert Smith LLP in association with Gleiss Lutz and Stibbe, "The Inside Track – How Blue Chip are Using ADR" (Nov. 2007), online: herbertsmith.com http://www.herbertsmith.com/NR/rdonlyres/FA4F7B4B-8246-404A-82CE-EF0019375CA7/5093/6398ADRreportD4.pdf 11 [Herbert Smith Report]. While two of the organizations were characterised as non-users of ADR, six preferred direct negotiations as their primary settlement tool, six were characterised as Ad Hoc users because they "held positive views of ADR processes but considered that a consistent approach to ADR use within their disputes portfolio was either unworkable or unnecessary" and seven were classified as "Embedded Users". Herbert Smith Report, 5; See also synopsis of the report in C. Ruckin, "Blue Chip Companies are turning toward ADR", Legal Week (19 Nov. 2007), online: Law.Com http://www.law.com/jsp/article.jsp?id=1195207449708# [Ruckin].

[74]See ibid 5, 29 and 31.

[75]LoPucki and Weyrauch (n 3) 1405.

[76]See H. D. Lasswell, and M. Smith McDougal, *Jurisprudence for a Free Society: Studies in Law, Science and Policy* (Martinus Nijhoff/Kluwer Academic Publishers, 1992) 2.

success[77] and a rejection of the traditional legal system. This suggests true legal strategy.[78]

For example, while most companies surveyed for the Herbert Smith report were in favour of ADR, they were not in favour of ADR clauses and their contractual repercussions.[79] Furthermore the report suggests that arbitration, and its increasing aping of the traditional court system,[80] is falling by the wayside with mediation becoming the ADR process of choice for commercial disputants.[81] Additionally, while these changes in corporate conflict resolution strategies have typically acted as incentive for law firms and barristers to develop ADR expertise, barristers are finding themselves being restricted by or aligned to the corporate view of ADR[82] and/or are being systematically excluded from corporate mediation policies and strategies,[83] as they are seen as more likely to hinder the process rather than help on account of their polarising effect on the parties.[84] Interestingly, the exclusion

[77]It has been said that culture is to an organization what personality is to an individual. Therefore, a strong corporate culture is likely to generate greater influence both inside and outside the company and is considered key to its success. See discussion in H. Makhlouk, and O. Shevchuk "The Importance and the Influence of the Corporate Culture in a Merger and Acquisition Context" 2008 *Baltic Business School* 50–52, online: DiVA Academic Archive On-line http://www.diva-portal.org/diva/getDocument?urn_nbn_se_hik_diva-415-2__fulltext.pdf; See also M. Schreader, and D. R. Self, "Enhancing the Success of Mergers and Acquisitions: an Organisational Culture Perspective" (2003) 41(5) Management Decision 511; See also E. H Schein, *Organizational Culture and Leadership* 2d ed. (Jossey-Bass Inc., 1992); See also Reilly and MacKenzie (n 14) 31–33.

[78]For further discussion on the advantages of designing and sustaining an alternative dispute system in the company see generally Reilly and MacKenzie (n 14) 19; See also McLaren and Sanderson (n 2) Chap. 10; See also discussion on institutionalising ADR in E. S. Fine, and E. S. Plapinger, eds., *Containing Legal Costs* (Butterworth Legal Publishers, 1988) s. V.

[79]See Herbert Smith Report (n 73) 36–38.

[80]See also for example, discussion on belief that commercial arbitration too often mimics court process, Honourable J. J. Spigleman AC (n 39) 2; See also for example, J. M. Sabitino, "ADR as 'Litigation Lite' Procedural and Evidentiary Norms Embedded within Alternative Dispute Resolution" (1998) 47 Emory L.J. 1289.

[81]Herbert Smith Report (n 73) 19, 4, 7 and 13; See also for example, H. N. Mazadoorian, "Building an ADR Program: What Works, What Doesn't" (1999) 8(4) American Bar Association: Business Law Today 37; For discussion of findings where the embrace of ADR "demonstrated more than a set of techniques added to those the company uses but represents a change in a company's mind-set about how it needs to manage conflict" see Lipsky and Seeber, *In Search* (n 12) 151.

[82]Herbert Smith Report (n 73) 5, 31–32.

[83]See general discussion in Herbert Smith Report (n 73) 31–33 and 5 and 13; "Both lawyers and arbitrators must be seen to deliver a cost effective service or they may very well find themselves bypassed by the requirements of commerce". Honourable J. J. Spigleman AC (n 39) 2.

[84]Herbert Smith Report (n 73) 23; See also Ruckin (n 73); See also Schneider (n 16) 113–114; See also C. Noble, L. Leslie Disgun, and D. Paul Emond, "What Are the Disputants' Differences and to What Extent Does Their Antagonism Impede Resolution?" *Mediation Advocacy: Effective Client Representation in Mediation Proceedings* (Emond Montgomery Publications, 1998) Chap. 7; See also D. Tannen, "The Argument Culture" (Ballantine Publishing Group, 1999); See also C. Menkel-Meadow, "The Trouble with the Adversary System in a Post-Modern, Multi-Cultural World" (1996) 1 J. of Inst. for the Study of Legal Ethics 52–53.

of lawyers from dispute resolution processes also neatly removes further potential limitations that might arise from professional codes of conduct and ethics considerations.[85]

The assumption of ADR culture into corporate practice to the exclusion of traditional legal players goes beyond mere tactics and improving best practices or operational effectiveness. Arguably, it can be characterised as a flexible, long-term strategy of *appropriation* of what was formerly solely legal province. Hence, recourse to ADR as a strategy can be seen to have evolved from simple advantages gained from the set off or manipulation of parallel regimes to potential competitive advantage gained through the effective elimination or perhaps, acquisition, of another regime or process.[86] Additionally, corporate culture and industry norms once established and recognisable, can continue to generate further advantage, through the strong influences those norms can have on external processes including shaping the development of the common law in the courts.[87]

That being said, the *appropriating* strategy as described above will no doubt still be subject to an ongoing tug of war, whereby legal territory is sought to be reclaimed by traditional legal players and institutions. For example, the debate as to when and how the jurisdiction of the courts can be properly ousted, if at all, has been and continues to be subject to extensive and longstanding scrutiny and discussion.[88] There also exists, from the public interest faction, a recurring need to assess and redress ADR, in terms of the role it plays in a just society and

[85]See for example discussion in G. A. Derwin, "The Principle of Proportionality in Dispute Resolution: Justice Must be Served" (2008) Canadian Bar Association: Possibilities (Newsletter), online: cba.org http://www.cba.org/CBA/newsletters/adr-2008-2/PrintHTML.aspx?DocId=32050#article1.

[86]Another example of appropriation can be observed in the growing practice of arbitral tribunals to continue with their proceedings and rendering awards notwithstanding that an injunction has been issued by the court of the place of arbitration enjoining their proceedings. See cases: *Himpurna California Energy Ltd v. The Republic of Indonesia*, extracts of the interim award dated 26 September 1999 and the final award dated 16 October 1999 in the *ICCA Yearbook of Commercial Arbitration* (Vol XXV-2000) at 109–215 and ICC Case No. 10623, 8 European Commercial Case (1985) 101 and discussion in C. Partasides, "Solutions Offered by Transnational Rules in Case of Interference by the Courts of the Seat" (2004) 1(2) Transnational Dispute Management, online: Solutions offered http://www.transnational-dispute-management.com/samples/freearticles/tv1-2-article204b.htm.

[87]For example, corporate norms and standards are frequently used by courts to interpret contractual relationships. See for example, *British Road Services Ltd. v. Arthur B. Crutchley and Co. Ltd.* [1967] 2 All E.R. 785 aff'd [1968] 1 All E.R. 811 (Eng. C.A.); *Kendall v. Lillico* & Sons Ltd. [1969] 2 A.C. 31 at 113; and *Anticosti Shipping Co. v. St. Amand* [1959] S.C.R. 374–375; For an example of the influence of corporate lawyers on creation of new legal knowledge and creation of new case-law and statute law see M. J. Powell, "Professional Innovation: Corporate Lawyers and Private Lawmaking" (1993) 18(3) Law and Social Inquiry 423.

[88]See for example discussion in C. M. Schmitthoff, "Arbitration: the Supervisory Jurisdiction of the Courts" (1967) The Journal of Business Law 318 [Schmitthoff]; See also Nelson (n 2) 135–138; See also O. M. Fiss, "Against Settlement" (1984) 93 Yale L. J. 1073; See also Redfern and Hunter (n 4) 1–139.

applicability of public norms and values.[89] For example, integrative initiatives like legislated mandatory mediation are being re-conceptualised by some as the new equity.[90] Additionally, it can also be observed that the legal community is attempting to regain lost ground through initiatives such as the mandatory use of ADR in the courts,[91] judicially assisted dispute resolution,[92] its own accreditation of neutrals[93] and development of national mediation (and arbitration) rules.[94]

It remains to be seen to what extent the legal community can recapture control of the mediation and arbitration processes. However, as already discussed, the call for the regulation of legal strategies offensive to current public policy is likely to arise.[95] Additionally, notwithstanding the increasing privatisation of ADR, it must be kept in mind that the general question of enforceability of agreements at minimum, will, in most jurisdictions, always reside in the domain of the traditional regime, albeit in varying degrees.[96]

9.4 Conclusion

The recognition and/or identification of legal strategy theory, particularly as it relates to Alternative Dispute Resolution is clearly a developing area with the actual substance of legal strategy still remaining somewhat elusive. However, the existence of legal strategy in generating legal outcomes through the ADR processes is undeniable. This chapter is an attempt to provide a starting point for discussion in the illumination and classification of legal strategy in the context of ADR.

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[89]Nelson (n 2) 135–138.

[90]T. O. Main, "ADR: The New Equity" (2005) 74 U. Cin. L. Rev. 329.

[91]For example see discussion in P. M. Wald, "ADR and The Courts: An Update" 46 Duke L. J. 1445; See also J. Macfarlane, and M. Keet, "Civil Justice Reform and Mandatory Civil Mediation in Saskatchewan: Lessons from a Maturing Program" (2005) 42 Alta. L. Rev. 677.

[92]See for example discussion on the availability of judicially assisted dispute resolution in Canadian Forum on Civil Justice, "Cross Country Snapshot of Dispute Resolution" (2002) 4 News and Views, online: Issue 4 http://cfcj-fcjc.org/publications/newsviews-04/n4-snapshot.php; See also availability of judicial dispute resolution in Alberta, Canada and discussion in Justice J. A. Agrios, "A Handbook for Judicial Dispute Resolution for Canadian Lawyers" (2004) Canadian Bar Association, online: cba.org http://www.cba.org/alberta/PDF/JDR%20Handbook.pdf.

[93]See for example, UK Solicitors Regulation Authority, Civil and Commercial Mediation Accreditation Scheme, online: Solicitors Regulation Authority http://www.sra.org.uk/solicitors/accreditation/civil-and-commercial-mediation-accreditation-scheme.page.

[94]See for example, The ADR Institute of Canada, Inc. and its national rules for Commercial mediations and arbitrations, online: Rules & Protocols http://www.adrcanada.ca/rules/commercial_mediation.html and http://www.adrcanada.ca/rules/national_arb_rules.pdf.

[95]See *Dell Computer* (n 44) 218–222 for discussion on how statutory protection related to public order, for example, was restricted to the effect of the decision and did not apply to the subject matter of the dispute, in this case, a consumer dispute.

[96]See discussion in Schmitthoff (n 88).

From the transparent first order of *cataloguing*, *positioning* and *oppositioning* through the second order of *flipping* to the more sophisticated third order of *appropriating* where control and continuity of use of ADR gives players the opportunity to strategically create a process that is not dependant upon the legal system for its success, ADR legal strategies build upon one another and become increasingly complex. Their desirability, development and implementation, arguably also require a corresponding increase in demand on company resources.[97]

Arising out of choice, predictability and continuity, the proposed typology can be summarised as follows:

First Order – Traditional Strategies/The Muscle in Choice

- *Cataloguing* permits a company to canvass the advantages and disadvantages of each process and select the process most likely to provide the best overall advantage.
- *Positioning*, built upon *cataloguing*, permits a company to gain advantage in a second anticipated process through manipulation of the first.
- *Oppositioning* permits a company to gain advantage by bringing out the weaknesses in both regimes through compelling their simultaneous application and interaction.

Second Order – *Flipping*/The Power in Predictability

More dependent on the sophistication and expertise of the legal strategist, *flipping* permits a company to gain advantage through surprise attack on an undesirable legal construct/rule through reliance on another recently affirmed and therefore more persuasive legal construct/rule.

Successful *flipping* requires being able to accurately predict court selection of one legal construct over another. Therefore in order to implement this strategy successfully, the strategist must have accurate up-to-date knowledge of public opinion, current law and courtroom sentiment.

[97]For example, see discussion in Herbert Smith Report (n 73) 14: "We have not got sufficient disputes on the roster to justify using an ECA process. I don't think the business would applaud me for putting in place a system which could have a cost impact when actually there is no need for it". General Counsel, Manufacturing/Industrial; Additionally, "Five of the Embedded Users had volunteered to bear the costs of an ADR process to encourage a counterparty to engage, but this was exclusively where the counterparties lacked the financial means to share costs in the usual way". Herbert Smith Report ibid 25; Additionally, "There is a great deal of work to be done to try again to expand awareness about the benefits of mediation and facilitated dispute resolution. If we had more time and money there are many jurisdictions in which we would like to do more to improve the environments in which we do our jobs to resolve disputes and lower costs to the company. We sell into some of the most difficult countries on the planet. We don't want to be in disputes with our customers in those places and educating customers about mediation is an important way for us to grow". Senior Litigation Counsel, Manufacturing/Industrial. Herbert Smith Report ibid 40.

Third Order – *Appropriating*/The Command in Continuity

Appropriating can perhaps be considered most akin to a true strategy and indeed, a true legal strategy in that it comprises a long-term plan of action that manipulates the application of the law and influences its future development. The incorporation of ADR into corporate culture situates the company as the spearhead of change in the ongoing development of ADR and increases its competitive edge and likelihood of success.

Observations

The foregoing examination and resultant typology do not readily illuminate a uniform legal strategy definition of general applicability. However, the following general observations can be made:

ADR has a more expansive reach than traditional court systems, despite national and international initiatives in that area, providing greater strategic opportunity for those companies that are resource able.[98]

Strategies implemented in the area of ADR are not equal. The strategies presented are at varying levels of sophistication and again, are likely also tied to the availability of resources for their development and implementation.[99]

Because ADR and law are both techniques in pursuit of a goal,[100] it can be deduced that the substance of legal strategy must be connected to policies behind those techniques, whether internal or external to a company. Therefore it might be said that legal strategy results, at least in part, from policies in conflict or at odds with each other. This observation is theoretically consistent with and can be used to equally describe the first, second and third orders discussed, namely, *cataloguing*, *positioning*, *oppositioning*, *flipping* and *appropriating*.

Further, these strategies can also be grouped or perceived as both vertical strategies, i.e. strategies between the corporation and regulator (as opposed to horizontal strategies or those between competitors) and collaborative or collective strategies, i.e. ones that require or involve the interaction of a number of actors. Briefly put, the ADR legal strategies discussed herein appear to be vertical and collective and aimed at enhancing a group advantage. Hence, ADR legal strategies can also be described as similar or comparable to a form of "lobbying"[101] or "social learning".[102]

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[98]Ibid.

[99]Ibid.

[100]For example, see discussion in Masson (n 40).

[101]Lobbying involves the idea that political factors and/or political interest groups/individuals can lobby and shape the development of legislation to provide them with benefits. See for example, discussion on group interest politics in M. Kahan, and E. Kamar, "The Myth of State Competition in Corporate Law" (2002) 55 Stan. L. Rv. 648–686; Here, legislators are seen as having little to do with formulating policy but rather are simply translating into law, the outcome of a particular interest group struggle. See K. Linos, "Social Learning and the Development of Corporate Law" (2006) Harvard Law School 14, online: law.harvard.edu http://www.law.harvard.edu/programs/olin_center/corporate_governance/papers/Brudney2006_Linos.pdf [Linos].

[102]Social learning in the context of law can be loosely described as the notion that legal change is driven by actors mimicking one another as information (whether legitimate or not) accumulates

Legal strategies have been described as being the "primary determinants of who will decide cases, under what constraints, and with what consequences".[103] Even the most perfunctory glance at how ADR is perceived and utilised by business and legal communities alike reveals that legal strategies aimed at controlling and manipulating outcomes are clearly at play. The elucidation and acknowledgement of ADR legal strategies "captures the reality"[104] of the ADR regime – that is, for many disputants it may not be as much about transforming conflict as it is about appropriating the process for its own objectives.

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in a public domain. Related areas of study use the terminologies of diffusion, policy transfer, lesson-drawing and learning. See discussion in Linos (n 101) 15–17; See also K. Linos, "Note, When do Policy Innovations Spread? Lessons for Advocates of Lesson-drawing" (2006) 119 Harv. Law Rev. 1467; See also generally J-P. Gond, and O. Herrbach, "Social Reporting as an Organisational Learning Tool? A Theoretical Framework" (2006) 65(4) Jour. Business Ethics 359.

[103]LoPucki and Weyrauch (n 3) 1412–1413.

[104]Ibid 1410.

Chapter 10
Strategic Planning to Avoid Organizational Criminal Liability: A Canadian Perspective

Darcy L. MacPherson

Abstract In this contribution, the author comments on a recent statutory amendment to the law of organizational liability in Canada. Specifically, he argues that, in the case of partnerships, the statutory language allows for strategic planning in the operations of the organization so as to limit the applicability of the criminal law to the organization. The author describes why this analysis is important, as it may lead to further statutory amendment.

Although the language of the statute does provide an opportunity for legal strategy, the result of such strategy would be inconsistent with many areas of the law. These include the law of partnership, fiduciary law and agency law. In addition, strategic planning is antithetical to the criminal law in general. More specifically, both the common law roots of organizational criminal liability (in the corporate context) and the general Parliamentary intent in passing the statute were designed to hold organizations *more* accountable to the criminal law, and *not* allow the avoidance of accountability. Finally, the author provides comment on some potential options for legal reform that might eliminate strategic planning opportunities.

10.1 Introduction

The question of strategic operations by business entities so as to avoid responsibilities imposed by prevailing legal norms has become an idea of increasing interest to scholars over the last decade and a half.[1] This issue is particularly acute in corporate law.[2] The "strategic" approach to legal norms suggests that lawyers can

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[1]L. M. LoPucki, and W. O. Weyrauch, "A Theory of Legal Strategy" (2000) 49 Duke L.J. 1405; an edited reprint in this text at Chap. 4 [LoPucki and Weyrauch].

[2]See for example, M. T. Moffat, "Directors' Dilemma – An Economic Evaluation of Directors' Liability for Environmental Damages and Unpaid Wages" (1996) 54 U. T. Fac. L. Rev. 293, paras. 27–29 where "risk-shifting strategies" are discussed.

A. Masson and M.J. Shariff (eds.), *Legal Strategies*,
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craft answers to legal problems, often through pre-emptive action.[3] Put simply, the strategic approach holds that the decision-making of lawyers can be more determinative of litigation outcome than are the objective "facts" and "law".[4]

This article accepts the strategic approach as a basic premise and makes the argument that (1) a recent Canadian statutory amendment with respect to organizational criminal liability has left gaps in its language and (2) these gaps implicitly encourage the type of strategic planning that is the lynchpin of this approach. When this occurs, it is hardly surprising that lawyers will take advantage, but understanding how the choice of statutory language may contribute to the problem is a key step to deterring such opportunistic behaviour.

Part II focuses on the development of organizational criminal liability in Canada, beginning with the common law and moving on to the statute and discusses how it differs from its common law predecessor. Part III identifies in detail, the particular issue of strategic planning raised by the statute and explains the importance of the matter at issue. Part IV then sets out three reasons why this particular statute should avoid gaps that allow for this type of strategic planning exercise. Part V looks at how gaps that allow strategic planning opportunities can be closed – or at least significantly narrowed – by some very simple changes to the statutory language.

10.2 The Common Law and the Statute

10.2.1 The Common Law

The Canadian common law on organizational criminal liability can be summarised as follows:[5] at common law, organizational liability was usually discussed in terms of corporate actors.[6] While the corporation has no actual *mens rea* of its own,[7] under what is known alternatively as the "identification doctrine" or the "attribution doctrine",[8] an individual's *mens rea* can be attributed to the corporation.[9] In other words, an individual can be the "conduit" to the corporation. In order to be such a

[3]LoPucki and Weyrauch (n 1) Part IV.

[4]Ibid.

[5]A more fulsome discussion of this issue can be found in D. L. MacPherson, "Extending Corporate Criminal Liability?: Some Thoughts on Bill C-45" (2004) 30 Man L.J. 253.

[6]See G. Williams, *Textbook on Criminal Law*, 2nd ed. (Stevens & Sons, 1983) 969.

[7]Ibid 970.

[8]Although these two terms are sometimes used interchangeably, the term "identification doctrine" is more common in Canadian parlance while the term "attribution doctrine" is more commonly used in the United Kingdom. Also, the term "theory" can be substituted for the term "doctrine". Regardless of the terminology, the reference is to the same legal device by which *mens rea* of an individual becomes that of the juristic personality of the corporation.

[9]See in Canada: *Canadian Dredge & Dock Co. v. The Queen* [1985] 1 S.C.R. 662 [*Canadian Dredge*] *per* Estey, J. for the Court and *The "Rhône" v. The "Widener"* [1993] 1 S.C.R. 497 [*The Rhône*] *per* Iacobucci, J. for the majority; In the United Kingdom see *Tesco Supermarkets*

conduit, the individual who committed the crime must be what is referred to as a "directing mind".[10] In order to be a "directing mind", the actions must fall within the "governing executive authority" given to the individual, meaning: (1) the individual must be a person who sets policy in the corporation; and (2) the activity said to be criminal must fall within this authority.[11] This requirement means that the designation of an individual as a "directing mind" of the corporation is activity-specific. That is, an individual may be a directing mind for one purpose but not for others. Under the common law, the fault element must be found in a single individual.[12] Generally, the directing mind is also liable for the offence.[13]

At common law, there were three "defences" available to this application.[14] The first of these is where the activity was not within the field of operation assigned to the directing mind. While this may appear to simply restate the activity-specific nature of the designation, in fact, the case-law suggests that this defence is used where, although the person is technically in charge of the operations of the company, the actions of the directing mind are such that these actions are not properly considered actions of the corporation.[15] The second defence is applicable where the person who would otherwise be a directing mind of the corporation is committing the criminal act in an attempt to make a victim of the corporation.[16] The

Ltd. v. Nattrass, [1972] A.C. 153 (H.L.). and *A.G.'s Reference (No. 2 of 1999)* [2000] Q.B. 796 (C.A.) [*A.G.'s Reference*].

[10]*Canadian Dredge* (n 9) 682; *The Rhône* (n 9) 520.

[11]*The Rhône* (n 9) 520.

[12]*A.G.'s Reference* (n 9) 815.

[13]*Canadian Dredge* (n 9) 682.

[14]Interestingly, the Court in *Canadian Dredge* makes it clear that although these are referred to (even in its own judgment) as "defences", in fact the Crown must prove that they do not apply. See *Canadian Dredge* (n 9) 713.

[15]In *Eastern Chrysler Plymouth Inc. v. Manitoba Public Insurance Corp.* [2000] 7 W.W.R. 643 (Man. Q.B.), aff'd [2001] 1 W.W.R. 626 (Man. C.A.) [*Eastern Chrysler*] the chief executive officer of the plaintiff corporation became inebriated and drove a company car. When the car was damaged as a result, the defendant insurer refused to pay, claiming that the insured, the plaintiff company, could not recover for its own bad acts. The insured corporation took the refusal to court. The court held that the acts of the CEO could not be attributed to the corporate insured. Therefore, the insured was allowed to recover under the insurance policy because the bad acts (with the necessary *mens rea*) of the individual executive were not those of the corporation.

[16]Justice Estey uses a number of different explanations to elucidate this defence in *Canadian Dredge* (n 9) 713. For example, he writes: "Where the directing mind conceives and designs a plan and then executes it whereby the corporation is intentionally defrauded, and when this is the substantial part of the regular activities of the directing mind in his office, then it is unrealistic in the extreme to consider that the manager is the directing mind of the corporation. His entire energies are, in such a case, directed to the destruction of the undertaking of the corporation. When he crosses that line he ceases to be the directing mind and the doctrine of identification ceases to operate". Justice Estey speaks of situations where the directing mind "conceives and designs a plan and then executes it whereby the corporation is intentionally defrauded" and where the scheme undertaken by the directing mind is driven at "the destruction of the undertaking of the corporation". These may not necessarily be the same thing, although the application of the two will clearly often overlap.Also, at one point, Justice Estey writes that: "Where this entails fraudulent action,

third defence is two-pronged. First, there must be no benefit intended to accrue to the corporation by the directing mind in carrying out the criminal act. Second, it must also be true that no benefit actually accrued to the corporation by the criminal act.[17] The foregoing provides a useful summary of the basics of the identification doctrine, for the purposes of the remainder of this chapter.[18]

10.2.2 The Statute

In 2003, the Canadian Parliament passed Bill C-45[19] to amend its *Criminal Code*[20] and alter its stance on organizational criminal liability. Several changes to the common law were made by the new statutory enactment. First, under the statute, other organizational forms in addition to the corporation are covered, including partnerships.[21] Second, instead of requiring a "directing mind" as the conduit to organizational liability, the new term of importance is whether the individual is a "senior officer" of the organization. The term "senior officer" includes all individuals who would be directing minds under the common law, but then also includes mid-level managers without policy setting authority.[22]

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nothing is gained from speaking of fraud in whole or in part because fraud is fraud". But in the very next paragraph Justice Estey also writes: "Where the criminal act is *totally* in fraud of the corporate employer and where the act is intended to and does result in benefit *exclusively* to the employee-manager, the employee-directing mind, from the outset of the design and execution of the criminal plan, ceases to be a directing mind of the corporation and consequently his acts could not be attributed to the corporation under the identification doctrine" [Emphasis added]. Therefore, based on Justice Estey's judgment, the question of whether the fraud must be "total" is uncertain.

[17] *Canadian Dredge* (n 9) 713.

[18] In *Meridian Global Funds Management Asia Ltd. v. Securities Commission* [1995] 2 A.C. 500 (P.C. N.Z.) [*Meridian*] the court held that notwithstanding the general applicability of the identification doctrine as will be described herein, there are circumstances where the doctrine needs to be adjusted to adapt to certain realities in the broad variety of situations in which the doctrine may find application. However, this does not lead me to conclude to question the general rules discussed herein. Rather, it is a recognition that in a limited number of cases, the general rules should not be applied. However, this means that the general rules, discussed herein, *do* apply to the vast majority of cases. So, rather than having an exception that casts doubt on the importance of the identification doctrine, the judgment in *Meridian* actually serves to underscore it.

[19] *An Act to Amend the Criminal Code (Criminal Liability of Organization)* S.C. 2003, c. 21 [Bill C-45].

[20] The Criminal Code R.S.C. 1985, c. C-46, as amended by Bill C-45 [Code].

[21] See "organization" in s. 2 of the *Code*, ibid. Interestingly, in a point that we will return to, the definition of the term "organization" is deliberately open-ended.

[22] The definition of "senior officer" in s. 2 of the *Code*, ibid, reads as follows: "'senior officer' means a representative who plays an important role in the establishment of an organization's policies or is responsible for managing an important aspect of the organization's activities and, in the case of a body corporate, includes a director, its chief executive officer and its chief financial officer". The first part covers directing minds, the second part includes mid-level managers, and the third part provides specific, title-based inclusions.

Third, the "senior officer" designation is for certain purposes, *not* activity-specific, because the statute specifically so provides. Para. 22.2(c) of the *Code* (a section added by Bill C-45) reads as follows:

> 22.2 In respect of an offence that requires the prosecution to prove fault – other than negligence – an organization is a party to the offence if, with the intent at least in part to benefit the organization, one of its senior officers
> [. . .]
>
> (c) knowing that a representative of the organization is or is about to be a party to the offence, does not take all reasonable measures to stop them from being a party to the offence.

Paragraphs (a) and (b) of the same section – which deal with the senior officer being party to the offence and directing others to carry out the act or omission which forms the basis of the offence, respectively – each include the words "acting within the scope of their authority", meaning that they are activity-specific. However, paragraph (c) does not include these words, meaning that, in general, the intent of the legislature must have been different than for the other two paragraphs.[23] Therefore, if a senior officer knows of the wrongdoing of a corporate representative,[24] regardless of whether the wrongdoing is within an area over which the senior officer has no control, the corporation may be held liable pursuant to para. 22.2(c).

Fourth, unlike the common law, it is now possible to convict the organization without convicting the individual who serves as a conduit to the organization. Under s. 22.2(c), the corporation can be liable because (1) a representative commits the underlying offence; (2) a senior officer has knowledge of the wrongdoing of the representative; and (3) the senior officer does not take all "reasonable measures" to prevent the wrongdoing. Yet, while this is enough to convict the representative, because the representative is still independently responsible for his or her own crimes, the representative is not the conduit to the organization. A senior officer is necessary. Yet, knowledge by the senior officer and failure to prevent the wrongdoing of someone else – in this case, the representative – is not sufficient to hold the senior officer personally liable for any crime.[25]

Fifth, the statute makes certain changes with respect to the defences. The first change is that the Crown is explicitly and unequivocally given the burden of disproving the application of the "defences" on the facts before the court. It is clear from the opening words of s. 22.2 (quoted above), that if there is no intention

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[23]R. Sullivan, *Sullivan and Dreidger on the Construction of Statutes*, 4th ed. (Butterworths, 2002) 386 [Sullivan].

[24]The term "representative" is defined to include any director, partner, employee, member, agent or contractor of a corporation. *Code* (n 20) s. 2, "representative".

[25]*R. v. Dunlop and Sylvester*, [1979] 2 S.C.R. 881, 898, *per* Justice Dickson as he then was, for the majority. With the exception of a single section creating a legal duty on all individuals who control the work of others to ensure a safe working environment (by the creation of a new s. 217.1 in the *Code*), Bill C-45 is concerned with the criminal liability of organizations, not individuals. Therefore, Bill C-45 does not alter the common law with respect to the individual liability of the senior officer.

on the part of the senior officer to benefit the organization through the scheme undertaken which is said to be criminal, the organization cannot be convicted. Although the language is somewhat ambiguous on this point, it seems likely that any court would refuse to hold the organization liable where the individual who committed the offence had no responsibilities or connection to the organization.[26]

This shows that the "fraud on the corporation" defence at common law remains viable under the statute. After all, if the corporation is the intended victim of the scheme, it is difficult to imagine that the Crown could prove intent to benefit the organization where the organization is the intended target of, for example, a fraud.

However, the third "defence" was clearly altered and in fact, was made easier to use from the point of view of the defendant. As mentioned earlier, under the common law, an actual but unintended benefit to the corporation would be sufficient to disentitle the defendant from the use of the third defence. Under the statute however, the organization would be entitled to keep an actual but unintended benefit without such a benefit leading to potential criminal liability.

Thus, in some ways, the statute makes it easier to convict organizations than its common law predecessor. On the other hand, in different ways, the statute actually makes it easier for the defendant organization to *avoid* liability. Therefore, depending on the goals of the legislation (which we will discuss in more detail in Part IV), the statute may not be achieving its full potential.

10.3 The Particular Issue

10.3.1 The Statutory Provisions

Having set out the general background for the statutory changes above, attention can now be turned to the particular issue which is the subject of this paper. Three definitions are essential to this discussion. They are:

> "organization" means
>
> (a) A public body, body corporate, society, company, *firm, partnership,* trade union or municipality, or
> (b) An association of persons that
>
> (i) is created for a common purpose,
> (ii) has an operational structure, and
> (iii) holds itself out to the public as an association of persons;
>
> "representative", in respect of an organization, means a director, partner, employee, member, agent or contractor of the organization;
>
> "senior officer" means a representative who plays an important role in the establishment of an organization's policies or is responsible for managing an important aspect of the

[26]See *Eastern Chrysler* (n 15).

organization's activities and, in the case of a body corporate, includes a director, its chief executive officer and its chief financial officer;[27]

What is relevant is that a partner is not, by definition alone, a "senior officer" of his or her partnership. However, it is clear that the legislature did turn its collective mind to the position of partners in the statutory scheme, given that partners are specifically included in the definition of "representative". Therefore, the idea of an accidental legislative gap is unlikely. This was a deliberate choice by the legislature. A partner is not the conduit to the partnership unless the individual partner is involved in management of the business of the partnership. However, simply because the legislature turns its mind to the issue does not necessarily mean there was an appreciation of the potential impacts of this policy choice. One of these impacts is that the statute provides the opportunity for the partners to plan the partnership's management structures in such a way as to avoid the criminal liability that might otherwise attach to the activities of the partnership. It is to this issue that attention now turns.

10.3.2 The Opportunity for Strategic Planning

Perhaps the best way to explain the opportunity for strategic planning presented by Bill C-45 is to compare and contrast two hypothetical scenarios. In the first of these, there is a law firm[28] with ten partners. Overall management of the firm rests with a five-partner Management Committee. One partner (also trained as a chartered accountant) is in charge of financial reporting issues. Another partner (the firm's expert on ethics) is in charge of professional liability, ethics, and conflict-of-interest situations. The three remaining partners are each in charge of one of the firm's

[27] *Code* (n 20) s. 2.

[28] In partnership statutes, a "firm" refers to all the persons who have entered into partnership with one another. See *Partnership Act*, C.C.S.M., c. P30, s. 6 [*Partnership Act* (Manitoba)]. While this example is drawn from Manitoba, the other Canadian common law provinces and territories have legislation with similar effect. See *Partnership Act*, R.S.A. 2000, c. P-3, s. 2 [*Partnership Act* (Alberta)]; *Partnership Act*, R.S.B.C. 1996, c. 348, s. 1 [*Partnership Act* (British Columbia)]; *Partnership Act*, R.S.N.B. 1973, c. P-4, s. 5 [*Partnership Act* (New Brunswick)]; *Partnership Act*, R.S.N.L. 1990, c. P-3, s. 5 [*Partnership Act* (Newfoundland and Labrador)]; *Partnership Act*, R.S. N.S. 1989, c. 334, s. 7 [*Partnership Act* (Nova Scotia)]; *Partnership Act*, R.S.N.W.T. 1988, c. P-1, s. 1 as duplicated for Nunavut by s. 29 of the *Nunavut Act*, S.C. 1993, c. 28 [*Partnership Act* (Nunavut)]; *Partnerships Act*, R.S.O. 1990, c. P.5, s. 5 [*Partnerships Act* (Ontario)]; *Partnership Act*, R.S.P.E.I. 1988, c. P-1, s. 6 [*Partnership Act* (Prince Edward Island)]; *Partnership Act*, R.S.S. 1978, c. P-3, s. 6 [*Partnership Act* (Saskatchewan)]; *Partnership and Business Names Act*, R.S.Y. 2002, c. 166, s. 5 [*Partnership Act* (Yukon Territory)]. Quebec has a partnership regime which in some ways mirrors that of its common law sister-provinces. However, there are important differences which are unique to Quebec. For a brief discussion of the Quebec partnership regime, see J. A. VanDuzer, *The Essentials of Canadian Law – The Law of Partnerships and Corporations*, 2nd ed. (Irwin Law, 2003) 26–27. However, our discussion will be restricted to the common law provinces.

major practice areas: (1) Corporate; (2) Litigation; and (3) Family. There are three associates per partner. All of the associates are employees of the firm. One of the associates in the Family Department is now engaged in a fraud that is intended to benefit both the associate and the firm. The benefits actually result to both the individual and the organization. At some point during the execution of the fraud, the partner in charge of the Family Department notices some unusually high bills that are going out. Upon investigation, the partner becomes aware of the fraud. The partner does not tell any other member of the Management Committee, nor the partner in charge of financial reporting issues. Nor does the partner attempt to stop the associate in the hope that large returns will be generated to the advantage of the firm. The fraud is perpetrated on several large clients of the firm. When the fraud is later discovered, both the associate executing the fraud and the partnership are charged with violating the *Criminal Code*'s prohibition on fraud with respect to property having a value of over $5,000.[29]

In this first scenario, it is clear that both the associate and the firm can be convicted. The associate's liability does not depend on that of the firm, but rather on his or her own *actus reus* with the required fault element. The firm can be convicted because: (1) the associate committed the *actus reus* with the required fault element; (2) the associate is a representative of the firm because he or she is an employee of the firm; (3) the partner is a senior officer, not because he or she is a partner, but because he or she has been placed in charge of the Family Department and therefore he or she manages an important aspect of the firm's activities; (4) the partner (who is a senior officer) has knowledge of the criminal wrongdoing of a representative of the firm, in this case the associate; and (5) the partner did not take all reasonable measures to prevent the continuance of the fraud following the partner's knowledge of it. Therefore, in the facts presented, the partnership is liable for the fraud perpetrated by the associate pursuant to the terms of para. 22.2(c) of the *Code*.

In the second scenario, we have another ten-partner law firm with thirty associates, all of whom are employees of the firm. One of the associates in the Family Department again commits an ongoing fraud against client of the firm, with the intention of benefiting both the associate and the firm. During the course of this fraud, a partner in the Family Department becomes aware of the fraud and does nothing to prevent it. The difference in this scenario is the management structure of the firm. Rather than three partners who are department heads, a five-partner Management Committee, a specific ethics expert, and a partner in charge of financial issues, all of these roles are combined in one person: the Senior Partner. The partner who discovers the fraud in advance of its continuing commission is NOT the Senior Partner.

In this second scenario, the associate is still liable for the fraud on a personal level and is still a representative of the partnership. A partner was still aware of the fraud before it was completed and did nothing to prevent its continuance. Yet, all

[29] *Code* (n 20) s. 380(1)(a).

management functions are vested in the Senior Partner. The Senior Partner is thus the only senior officer of the partnership. Since no senior officer knew of the wrongdoing, para. 22.2(c) of the *Code* is not satisfied. Therefore, it is impossible to hold the partnership liable.[30]

10.3.3 Why Is This Important?

As set out above, the statute applies to all partnerships and all their activities. It is not limited to any type of business, or even to any particular form of partnership. Yet, in the process of writing this chapter, people for whom I have a great deal of respect pointed out there have historically not been a lot of cases where the partnership (as opposed to the misbehaving partners personally) was pursued criminally. It is possible to argue, therefore, that the change made by Bill C-45 is of limited application. I do not agree with this position. There are many reasons for this. First, it is difficult to know the reason for this lack of prosecutions of partnerships. It could be due to the fact that there was relatively little wrongdoing in this form of business organization. However, I am not personally convinced of this. Without having conducted an empirical study to gather evidence, I believe far more likely that in fact, the lack of clarity about the ability to pursue non-corporate organizations criminally, led prosecutors to be satisfied with the prosecution of individuals, rather than the collective enterprises of which the individual formed a part. Put another way, the Canadian Parliament has now signaled an intention to pursue the partnership as a potential object of criminal sanction. The very fact of this signal may make partners take steps to protect their interests. Previously, this was not necessary because the law was unclear and prosecutions were rare. We will not know the actual effect of either the change brought about by Bill C-45 or the planning opportunity it presents for some time. It is possible that the effect will be

[30]Fraud is an offence where the prosecution must prove a fault element other than negligence. On this point, see *R. v. Théroux* [1993] 2 S.C.R. 5, 19: "The *mens rea* would then consist in the subjective awareness that one was undertaking a prohibited act (the deceit, falsehood or other dishonest act) which could cause deprivation in the sense of depriving another of property or putting that property at risk". *per* Justice McLachlin (as she then was) for the majority. Section 22.2 of the *Code* thus applies. Section 22.1 of the *Code* applies where an organization is charged with an offence where the Crown must prove a fault element of negligence. Paragraphs 22.2(a) and (b) provide that the organization is liable where the senior officer (a) acting within the scope of their authority, is a party to the offence; (b) having the mental state required to be a party to the offence and acting within the scope of their authority, directs the work of other representatives of the organization so that they do the act or make the omission specified in the offence. Paragraph (a) applies where the senior officer is directly involved in the offence, meaning that the senior officer committed the offence, or aided or abetted the commission of the offence (see s. 21 of the *Code*, n 20). There is nothing on the facts presented to show that the Senior Partner meets any of these criteria. With respect to paragraph (b), there are no facts that suggest that the Senior Partner had the requisite *mens rea*. Therefore, paragraph (b) does not apply. This leaves only paragraph (c), which is also dismissed by the analysis offered above. *Code* (n 20) ss. 21, 22.1 and 22.2.

minimal. However, until we are certain what the effect is, my goal in this chapter is to make the law as clear and coherent as possible.

Second, it was said that if this is as important an issue as I claim, Parliament will fix it by statutory amendment. It is true that Parliament can fix this, as discussed in Part V below, however, the Canadian experience in this area is that it takes a good deal of time for the political will to develop to make these kinds of changes to the law. Bill C-45 is proof of this. Bill C-45 was passed in 2003,[31] yet, the disaster that precipitated the legislative enactment occurred in 1992.[32] In other words, even assuming that Parliament knows of the potential gap, public discussions of improvement may assist in establishing the need for change.

Third, it was also pointed out that most Canadian businesses, including partnerships, will avoid criminal liability. Thus, it is said, that the planning opportunity will not be taken up. I agree that most business people are moral and apply the same rules to their business lives. But the reality is that there are a variety of notable exceptions to this general statement. If society does not wish to encourage such persons to avoid basic responsibilities imposed by societal morality, closing loopholes, such as the strategic planning opportunity referred to in this chapter is necessary. Therefore, I believe this discussion is important to promote coherence and consistency in the law.

From the foregoing analysis, the opportunity for strategic planning becomes apparent. The simple act of altering the management structure of the firm can potentially change the criminal liability of the organization. If this is so, then it seems to me that the next logical question is the following: Does this result conform to our understanding of the other areas of law involved?

10.4 The Inconsistency Between This Strategic Planning Opportunity and Other Areas of Law

10.4.1 Agency, Fiduciary and Partnership Law

It is clear that partnership law has as its basis, the law of agency.[33] In particular, mutual agency is at issue in partnership cases.[34] Every partner is a fiduciary of every

[31]Bill C-45 (n 19).

[32]Canada, Minister of Justice, "Bill C-45", (Press Release) online: Department of Justice http://www.justice.gc.ca/eng/news-nouv/nr-cp/2003/doc_30922.html.

[33]A. R. Manzer, *A Practical Guide to Canadian Partnership Law* (Canada Law Book, 1994-) para. 3.1360; See also R. C. I'Anson Banks ed., *Lindley & Banks on the Law of Partnership*, 18th ed. (Sweet & Maxwell, 2002) 303 [*Lindley & Banks*].

[34]*Lindley & Banks*, ibid.

other partner and every partner is a beneficiary of the fiduciary obligations of every other partner.[35] Thus, all of the partners are both beneficiaries and fiduciaries of each other.[36]

This means that each partner has multiple fiduciaries in the form of all the other partners. The primary obligation of any fiduciary is to be loyal[37] in the protection of the interests of the beneficiary.[38] The need for disclosure in transactions between the fiduciary and his or her beneficiary follows from this requirement. The fiduciary must protect the beneficiary by either not entering into transactions where there is either actual or potential conflict of interest between the fiduciary and the beneficiary,[39] or by ensuring that full disclosure is made to the beneficiary, such that the beneficiary can protect him- or herself.[40] This establishes the following: (1) that the needs of the fiduciary cannot be allowed to conflict with those of the beneficiary; and (2) communication between the fiduciary and the beneficiary can give the beneficiary the ability to protect their own interests.

Where, as here, there are multiple fiduciaries for each beneficiary, communication between the fiduciaries is necessitated.[41] Otherwise, how can one fiduciary protect the beneficiary when a second fiduciary has information which the second fiduciary is withholding from the first? Put another way, protection by multiple fiduciaries demands communication among those fiduciaries so that all those fiduciaries are working toward the same goal.

This is all the more evident when one looks at the definitions of partnership. One such definition is as follows:

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[35]L. I. Rotman, *Fiduciary Law* (Thomson Carswell, 2005) 120 note 292 [Rotman].

[36]Ibid.

[37]*Lac Minerals Ltd. v. International Corona Resources Ltd.,* [1989] 2 S.C.R. 574 [*Lac Minerals*] *per* Justice LaForest, 646.

[38]In *Lac Minerals*, ibid, the majority on the issue of fiduciary duty (Justice Sopinka, with Justice McIntyre, and Justice Lamer, as he then was, in separate reasons, concurring) held that first the relationships of both partners and principal and agent are "traditional" fiduciary categories. Second, as Justice Sopinka writes: "When the Court is dealing with one of the traditional relationships, the characteristics or criteria for a fiduciary relationship are assumed to exist. In special circumstances, if they are shown to be absent, the relationship itself will not suffice". In the examples provided, there are no "special circumstances" referred to. Therefore, this is sufficient to establish a fiduciary relationship. Justice LaForest (637) made it clear that he did not agree with the majority on the issue but makes it clear that he is basing his decision in the case on the principle of breach of confidence and in that context, sees a more limited role for fiduciary duty than does the majority. Justice Wilson (630), on the other hand, disagrees with the majority on the applicability of fiduciary duty, holding that the duty was in fact breached.

[39]*Aberdeen Railway Co. v. Blaikie* [1843–1860] All E.R. Rep. 249 (H.L.) 252 *per* Lord Cranworth.

[40]*Girardet v. Crease & Co.* (1987) 11 B.C.L.R. (2d) 361 (S.C.) 362 *per* Justice Southin, as she then was, and quoted with approval by Justice LaForest in *Lac Minerals* (n 37) 647.

[41]See Rotman (n 35) 335.

> Partnership is the relation which subsists between persons carrying on a business in common, with a view of profit; but the relationship between members of an incorporated company or association is not a partnership within the meaning of this Act.[42]

In order to have a partnership, there must be a business, carried on in *common*. This leads to the question: "How can there be a common goal between two or other people who do not communicate one with the other?" The short answer is that it would seem quite difficult to do so.[43]

So, in general, communication is essential to the mutual agency and fiduciary characteristics that underlie the relationship of partnership. Yet, para. 22.2(c) of the *Code* actually turns this obligation on its head. In our second scenario, the inability to hold the partnership liable under Bill C-45 is conditioned upon the fact that the Senior Partner, the only senior officer of the partnership, had no knowledge of the wrongdoing of the associate. This is true even if one of the partners other than the Senior Partner had the requisite knowledge of the wrongdoing of the associate. If the other partner shares his knowledge with the Senior Partner, the knowledge of the Senior Partner could in itself lead to criminal liability for the partnership, unless the Senior Partner takes all reasonable measures to prevent the crime from continuing. Therefore, paradoxically, while fiduciary duty would generally demand communication between partners, in some cases when Bill C-45 is potentially at issue, communication could be detrimental to the interests of the partnership.[44]

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[42] *Partnership Act* (Manitoba) (n 28) s. 3; *Partnership Act* (Alberta) (n 28) ss. 1(g) and 3; *Partnership Act* (British Columbia) (n 28) ss. 2 and 3; *Partnership Act* (New Brunswick) (n 28) s. 2.; *Partnership Act* (Newfoundland and Labrador) (n 28) s. 2(c); *Partnership Act* (Northwest Territories) (n 28) s. 2; *Partnership Act* (Nova Scotia) (n 28) s. 4; *Partnership Act* (Nunavut) (n 28) s. 2; *Partnerships Act* (Ontario) (n 28) s. 2; *Partnership Act* (Prince Edward Island) (n 28) s. 3; *Partnership Act* (Saskatchewan) (n 28) s. 3; *Partnership Act* (Yukon) (n 28) s. 2. [the *Partnership Acts*].

[43] This is not to suggest that all partnerships are intentionally created. In fact, they may be created by accident, or even contrary to the intention of the alleged partners. In fact, this is quite possible. On this point, see *Redfern Farm Services Ltd. v. Wright* [2006] M.J. No. 4 (Man. Q.B., Master). Instead, the suggestion here is that it would be unusual for the putative partners to become partners without communication between them.

[44] At one level, the partnership is synonymous with its members. At common law, it is clear that the partnership has no existence separate from its members. See *Re: Thorne and New Brunswick Workmen's Compensation Board* (1962) 33 D.L.R. (2d) 167 (N.B.C.A.) *per* Chief Justice McNair for the Court. English law takes the same position. See The Law Commission and The Scottish Law Commission, *Partnership Law – A Report on a Reference under Section 3(1)(e) of the Law Commissions Act 1965, Cm 6015* (2003) paras. 2.5 – 2.6 [The English and Scottish Law Commissions Report].Scottish law, on the other hand, holds that partnerships have separate legal personality from that of their members, based on a statutory provision that specifically provides for it. See *Partnership Act, 1890*, 1890, 24 & 25 Vict., c. 89 s. 4(2). See also The English and Scottish Law Commissions Report (n 44) paras. 2.7–2.8. No similar statutory language can be found in Canadian common law partnership statutes. Therefore, as far as the civil law aspects are concerned – civil law used as a counterpoint to the criminal law, not as a counterpoint to the common law – the fiduciary duty is owed to the other partners collectively. But once it is owed to all the partners collectively, it is owed to the firm. The "firm" is synonymous with the partnership. However, this does not resolve the issue of the position of the possible separate legal personality of the

The basic obligation of any fiduciary is to protect the best interests of the beneficiary.[45] It is clearly not in the best interests of the beneficiary to be pursued criminally by the Crown for the *mens rea* misdeeds of its agents or other employees. Therefore, there is a strong argument that the partner, who: (1) is not a senior officer; and (2) has the requisite knowledge, must ensure that the Senior Partner never becomes privy to this knowledge.

The paradox of this approach, if this argument is sound, has already been pointed out. The Senior Partner cannot protect the partnership (or his or her fellow partners) without the requisite information. Yet, the provision of the requisite information to the Senior Partner would place the Senior Partner in the position of needing to take all reasonable measures to prevent actions by the associate that could prove profitable to the partnership.

One other provision under the *Partnership Act*s is also important to this discussion. The Manitoba provision reads as follows:

> 27 The interests of partners in the partnership property and their rights and duties in relation to the partnership shall be determined, subject to any agreement, express or implied, between the partners, by the following rules:
>
> [. . .]
>
> (e) Every partner may take part in the management of the partnership business.[46]

Therefore, the *Partnership Act*s make clear that the default rule is that all partners are expected to have the ability to participate in the management of the partnership's business.[47] The only way to change this is through the agreement of all the

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partnership under Bill C-45. In "'Organizational' Criminal Liability of Partnerships in Canada: Some Constitutional and Practical Impediments to its Implementation" (Manitoba Law Journal, forthcoming), I address this issue at length. I do not intend to repeat the argument here. But, it is important to recognise that Bill C-45 *does* separate the individual partner from the partnership with which the partner is associated. This is the fundamental point of Bill C-45. Therefore, there is a substantial argument that Bill C-45 gives the partnership a separate legal personality for the limited purposes of the criminal law only. However, for the purposes of the discussion herein, whether the beneficiary is the partners individually or the partnership does not alter the analysis, and thus, whatever the academic interest the question may generate, we will leave that issue for another day.

[45]Rotman (n 35) 305: "The keystone of all fiduciary duties is the duty to act in the utmost good faith (*uberrima fides*) in a beneficiary's interests".

[46]*Partnership Act* (Manitoba) (n 28) s. 27(e); *Partnership Act* (Alberta) (n 28) s. 28(e); *Partnership Act* (British Columbia) (n 28) s. 27(e); *Partnership Act* (New Brunswick) (n 28) s. 25(e); *Partnership Act* (Newfoundland and Labrador) (n 28) s. 24(e); *Partnership Act* (Northwest Territories) (n 28) s. 24(e); *Partnership Act* (Nova Scotia) (n 28) s. 27(e); *Partnership Act* (Nunavut) (n 28) s. 24(e); *Partnerships Act* (Ontario) (n 28) s. 5; *Partnership Act* (Prince Edward Island) (n 28) s. 27(e); *Partnership Act* (Saskatchewan) (n 28) s. 26(5); *Partnership Act* (Yukon) (n 28) s. 26(e).

[47]While this is generally the case for general partnership, limited partnerships are a different animal. As a general rule, limited partners are not allowed to participate in the business of the partnership. See *Partnership Act* (Alberta) (n 28) s. 64; *Partnership Act* (British Columbia), (n 28) s. 64; *Limited Partnership Act*, R.S.N.B. 1973, c. L-17, s. 17(1); *Limited Partnership Act*, R.S.N.L. 1990, c. L-17, s. 16; *Limited Partnerships Act*. R.S.N.S. 1989, c. 259, s. 17; *Partnership Act*

partners. The issue therefore becomes whether the fact that the partners agree to an arrangement whereby the managerial power, which would otherwise be shared by all partners by virtue of para. 27(e) or its equivalent, is consolidated in one person (the Senior Partner) should alter the consequences of behaviour prohibited by the criminal law. In my view, the fact that anyone has the right, by virtue of their position or title, to participate in management, and by agreement or otherwise, choose not to exercise the rights granted to them in this regard, then the person should be considered a senior officer for the purposes of Bill C-45. However, we will return to this issue in Part V, below.

10.4.2 Criminal Law

The criminal law is essentially focused on morally reprehensible behaviour.[48] This is particularly true where we are focused on *mens rea* offences as opposed to public welfare offences.[49] It would seem incongruous to say that the basics of morality should change based on how a person chooses to order their affairs. Put another way, some criminal-law theorists say a conviction is a form of communication between society as a whole, on the one hand, and the offender, on the other.[50] The message is supposed to be an expression of society's moral condemnation of the act. If this is so, then does it not dilute the message of moral condemnation when that message is followed by an indication that if the defendant had just tried to accomplish the same goal in a different way, the defendant could have done so, and

(Northwest Territories) (n 28) s. 70, as duplicated for Nunavut by s. 29 of the *Nunavut Act*, S.C. 1993, c. 28; *Limited Partnerships Act*, R.S.O. 1990, c. L-16, s. 13(1); *Limited Partnership Act,* R.S. P.E.I. 1988, c. L-13, s. 12(1); *Partnership Act* (Saskatchewan) (n 28) s. 64; *Partnership Act* (Yukon Territory) (n 28) s. 63.Manitoba is an exception to the general rule, in that limited partners are allowed to participate in the business decisions of the partnership without losing their right to limited liability. See *Partnership Act* (Manitoba) (n 28) s. 58. However, since most limited partners are not allowed to (and many would not want to) actively participate in the business of the partnership, it is unlikely that they would: (1) be able to use the partnership as a platform for criminal acts, within their scope of authority (para. 22.2(a)); (2) within their scope of authority, direct others within the partnership to commit criminal acts (para. 22.2(b)); or (3) both obtain information with respect to the criminal activities of representatives, and be able to take reasonable measures to prevent it (para. 22.2(c)). Thus, limited partnerships – and limited-liability partnerships which are also a separate category from partnerships generally – will not receive extensive mention here. There may very well be additional issues with respect to these forms of business organization that may require a more detailed analysis to resolve than space restraints allow for here. Therefore, these potential issues will be left to another day.

[48]A. von Hirsch, *Censure and Sanctions* (Clarendon Press, 1993) 10–11.

[49]For the distinction between "true" criminal offences on the one hand and "public welfare" or "regulatory" offences on the other see, for example, *R. v. Sault Ste. Marie (City)*, [1978] 2 S.C.R. 1299, *per* Justice Dickson, as he then was, for the Court.

[50]R. A. Duff, *Punishment, Communication, and Community* (Oxford University Press, 2001) 80–82.

the strongest piece of moral condemnation available to the law would have found nothing wrong with this behaviour? Yet, this is the essence of the strategic approach to law. Thus, in theory, the criminal law should not be subject to strategic considerations. While there is always some room for flexibility in any statutory scheme as intricate and complex as the criminal law, this does mean that we should either: (1) encourage the exploitation of this inherent flexibility beyond reasonable limits; or (2) even worse, increase the flexibility of the statutory scheme so as to make this exploitation even easier.

Judicial interpretation has also taken this approach in the law of theft. In *R. v. Dawood*,[51] the defendant altered a product so that when she presented it to the cashier, she paid a lower price than she would have if she had not altered the product. The Alberta Court of Appeal held that the defendant, although guilty of obtaining property under false pretences,[52] was *not* guilty of theft.[53] Therefore, *how* the defendant achieved her result was a key element to the determination of the legal outcome. In my view, it matters little whether this was a result planned by the defendant in advance, on the one hand, or one developed by her counsel, on the other. Regardless, it demonstrates at least the possibility of strategic planning in advance by potential criminal defendants. However, when a similar case, *R. v. Milne*,[54] arrived in the Supreme Court of Canada, the Court wrote as follows:

> Where a transferor mistakenly transfers property to a recipient, and the recipient knows of the mistake, property does not pass for the purpose of the criminal law if the law of property creates a right of recovery, no matter whether the original transfer is said to be void or voidable. The distinction between void and voidable transfers has no purpose in the context of the criminal law. In either case, where the law of property provides at least a right of recovery, property does not pass for the purpose of the criminal law. If the recipient then converts the property to his own use, fraudulently and without colour of right, and with intent to deprive the transferor of the property, he is guilty of theft.[55]

By overruling *Dawood*,[56] the Supreme Court effectively reduces the number of avenues for strategic planning purposes. Although the judgment is not framed in explicit terms of legal strategy, the effect is the same. Where one party knows that the other has made a mistake in transferring property to the transferee, and the transferee take fraudulent advantage, this is theft from the transferee. The second matter of interest is that the Court in *Milne* draws a distinction between the civil law definition of "property" and that used for the criminal law. In both *Dawood* and *Milne*, for the purpose of property law (the civil law), property had passed to the defendant. In *Dawood*, the majority of Court of Appeal held that this civil law

[51] *R. v. Dawood* [1976] 1 W.W.R. 262 (Alta. C.A.), *per* McDermid, J.A., for the majority.

[52] Ibid 263, para. 3, and 265, para. 11.

[53] Ibid 265, para. 11.

[54] *R. v. Milne*, [1992] 1 S.C.R. 697, *per* Justice Gonthier, for the Court [*Milne*].

[55] Ibid 708–709, para. 29.

[56] *Milne* (n 54) 708, para. 26.

result, the passing of property, determined the result for the purposes of the criminal law. In *Milne*, on the other hand, the Court seems to appreciate the ability to separate the civil law from its criminal counterpart.[57] This more expansive definition of theft offered by *Milne*, as compared to the earlier more restrictive definition in *Dawood*, is particularly interesting given the general rule of statutory interpretation that statutes creating criminal offences are supposed to be interpreted restrictively.[58] However, this rule is rebuttable.[59] Also, there is yet another rule of statutory interpretation which holds that an interpretation of a statute that would derogate from the fundamental purpose of the statute is to be avoided if possible.[60] How the courts will choose to resolve this potential conflict between rules of statutory interpretation remains to be seen.[61]

10.4.3 Bill C-45 Itself and the Common Law of Corporate Criminal Liability

10.4.3.1 Bill C-45 Itself

Bill C-45 is quite clear that it is designed to reduce strategic planning opportunities, rather than increasing them. In a Backgrounder released on the same day that Bill C-45 was introduced in Parliament, the purpose of the legislation was described in part as follows:

> In the proposed legislation, the term "organization" is used rather than "corporation." "Organization" includes "a public body, a body corporate, a society, a company," taken from the existing *Criminal Code* definitions, but adds "a firm, a partnership, a trade union or

[57]This is not to say that form *never* matters in the criminal law. In fact, in an article entitled "'Organizational' Criminal Liability of Partnerships in Canada: Some Constitutional and Practical Impediments to its Implementation" (Manitoba Law Journal, forthcoming), I argue that there are several differences between the corporation and other forms of business organizations, notably partnerships. In that article, I argue that: (1) the most salient of these distinctions is the separate legal personality of corporations that is not afforded to partnerships; (2) Parliament seems to have ignored the impacts of this distinction within the language of Bill C-45 itself; and (3) this absence of information leads to a number of questions.

[58]Sullivan (n 23) 384–386.

[59]Ibid 387–390.

[60]Ibid 243–244.

[61]This is not the proper forum in which to even try to offer a suggestion on how to resolve the potential conflict between these principles. This is not to suggest that it is unimportant. On the contrary, any proposal for such a resolution would require a more nuanced and subtle argument than that which can be meaningfully presented within this chapter. Therefore, any thoughts on this issue will also have to wait for another day to find expression.

> an unincorporated association," which are new. *It is important to ensure that the same rules for attributing criminal liability apply to various forms of organizations regardless of the specific way they choose to structure their affairs.*[62]

Thus, the Backgrounder gives us some insight into the intention of the government of the day in introducing Bill C-45 into Parliament. While the italicised sentence does not use the words "legal strategies", it is evident to me that advanced planning of business affairs by those anticipating contact with the criminal justice system in an organizational setting was sought to be discouraged.

10.4.3.2 The Common Law

While the common law originally showed significant reluctance to hold corporations liable for most true criminal offences,[63] as the twentieth century progressed, this reticence was replaced by a realisation that modern vehicles used for commercial and other purposes must be subject to the oversight of the criminal law. As Justice Estey put it in *Canadian Dredge*, after reporting that the English courts had refused to import principles of vicarious liability into the criminal law:

> On the other hand, the corporate vehicle now occupies such a large portion of the industrial, commercial and sociological sectors that amenability of the corporation to our criminal law is as essential in the case of the corporation as in the case of the natural person.[64]

In *R. v. Church of Scientology*,[65] after quoting the above from *Canadian Dredge*, Justice Rosenberg, for the Court, extended this logic to non-commercial activities as well. He wrote as follows:

> The evidence in this case bears out the important role of the non-profit corporation in modern society. The latest figures available at the time of trial indicated that there were over 25,000 corporations without share capital incorporated in Ontario; that there were approximately 65,000 registered charities in Canada, and almost 30,000 of these carry out religious activities; and that Canadian taxpayers donated almost $3 billion to charities. To leave these organizations outside the purview of the criminal law would be intolerable. Some of the most important activities undertaken in society are performed under the

[62]Canada, Department of Justice, "Criminal Code Amendments Affecting the Liability of Corporations" (Backgrounder), online: Department of Justice http://www.justice.gc.ca/eng/news-nouv/nr-cp/2003/doc_30924.html.

[63]For a brief discussion of the historical evolution of corporate criminal liability, see D. L. MacPherson, "Reforming the Doctrine of Attribution: A Canadian Solution to British Concerns?", S. Tully ed., *Research Handbook* on *Corporate Legal Responsibility* (Edward Elgar, 2005) 194–195.

[64]*Canadian Dredge* (n 9) 692.

[65]*R. v. Church of Scientology*, (1997) 33 O.R. (3d) 65 (C.A.) Application for extension of time granted and application for leave to appeal to the Supreme Court of Canada dismissed April 9, 1998 (Lamer C.J. and McLachlin and Iacobucci JJ.) [*Scientology*].

> umbrella of the corporate vehicle. I can see no rational basis for adopting a different test for criminal liability, in the case of non-profit corporations solely because they do not have shareholders or because any profits are used to promote the objects of the corporation rather than to enrich the shareholders personally. The need for regulation of the conduct of the corporation through the criminal law is the same.[66]

Both of these quotations refer to the pervasiveness of corporations throughout modern society. It terms of sheer numbers, it is clear that the partnership cannot match its corporate counterpart in terms of societal importance. But, equally there can be little doubt that the tools of modern commercial life have become more complex, often incorporating more than one form of business organization to achieve specific (often tax-related) goals. In particular, corporations are often used in concert with both trust and partnership structures in many securitization and income-trust transactions.[67] If this is so, then other forms of business organization (including the partnership) are, at least in some cases, intimately tied to the use of the corporate form. Thus, the fact that the corporation is more often used than either trusts or partnerships does not invalidate the argument that – just as Justices Estey and Rosenberg held in *Canadian Dredge* and *Scientology*, respectively – there is sufficient activity occurring in partnerships for judges to hold that partnerships should be subject to the criminal law.

If the above argument – drawing the analogy of the common law's previous holding of the need for *corporate* criminal liability, on the one hand, and the potential need for criminal liability for other forms of business organization, including the partnership, on the other – is sound, then *Scientology* actually provides a common law basis for disallowing legal strategic planning. In *Scientology*, the Church of Scientology of Toronto was found guilty of certain offences when members of the Church were instructed by employees of the Guardian's Office to take jobs with government agencies perceived to be enemies of the Church to obtain information on behalf of the Church, in contravention of their obligations to their respective employers.[68] This summary alludes to the fact there were actually two

[66]Ibid 131.

[67]For example, in many securitization transactions (also called "asset-backed securities"), there is often a corporate originator of certain receivables. The receivables are often purchased by a "special-purpose vehicle" that is sometimes a partnership. Trusts are often used to actually issue the securities to the ultimate purchaser. See F. D. S. Choi, *International Finance and Accounting Handbook,* 3rd ed. (John Wiley & Sons Inc., 2003) 21.1–21.7. See also C.A. Stone, and A. Zissu, *The Securitization Markets Handbook: Structures and Dynamics of Mortgage- and Asset-Backed Securities,* 1st ed. (Bloomberg Press, 2005) 237–247. Similarly, in the recently-popularised business income trust, the underlying business actually remains in a corporation, while trusts issue securities to the public, and partnerships are often used as intermediate steps in the transactions. *Pizza Pizza Royalty Income Fund – Prospectus* (24 June 2005) 20, SEDAR filing dated 27 June 2005, online: SEDAR http://www.sedar.com/DisplayCompanyDocuments.do?lang=EN&issuerNo=00022262.

[68]*Scientology* (n 65) 75.

streams of organizations involved.[69] One was the Guardian's Office, whose function it was to protect the Church from its enemies, including through intelligence-gathering activities.[70] Each Church in the Scientology network was separately incorporated; for example, the Toronto Church was incorporated under the *Corporations Act* of Ontario.[71]

The members of the Church were directed by members of the Guardian's Office (Toronto) to carry out the activity later judged to be criminal.[72] Nonetheless, the Guardian's Office was not charged. The only organizational defendant was the Toronto Church,[73] not the Guardian's Office.[74] Nonetheless, an agent of the Guardian's Office was able to be the conduit, not to the Guardian's Office, but rather as a conduit to the Toronto Church, because the Guardian's Office could give orders to the Toronto Church.[75] Therefore, the person from the Guardian's Office who gave the order to carry out the activities judged to be criminal was a directing mind of the Church.[76] This is so, even though the Court clearly drew a distinction between the organizational structure of the individual church on the one hand, and the Guardian's Office, on the other.

In the end, due to the definitions of "senior officer" and "representative", the strategic planning opportunity offered to partners by the wording of Bill C-45 runs contrary to agency law (and the fiduciary duty that normally accompanies the agency relationship), as well as criminal law generally, and specifically, the thrust of both (1) the common law of corporate criminal liability; and (2) Bill C-45 itself.

[69]Ibid. The use of the term "streams of organizations" is quite deliberate. The judgment is clear that the Guardian's Office (Worldwide) had supervisory authority over the Guardian's Office (Toronto). Yet it is not clear whether Guardian's Office (Toronto) is a separate corporation. It is also clear that there were various levels within each stream, although both culminate with the same person, the Founder. Nonetheless, it is clear that the Court drew a distinction between the Guardian's Office, on the one hand, and the Church organizations, on the other. Therefore, despite the lack of clarity of the organizational relationships, this did not affect the judgment of the Court.

[70]Ibid 77.

[71]Ibid 76.

[72]Ibid 66.

[73]One individual, a Ms. Jacqueline Matz was also charged.

[74]*Scientology* (n 65) 66.

[75]Ibid.

[76]Ibid. There is at least an argument that the result would not be the same under the statute. For example, the statutory language requires that a "senior officer" be a "representative" of the organization charged with the offence. In order to be a "representative" of the organization, the person ordering the *actus reus* of the offence must fall within the classes of persons defined as "representatives". Arguably, the person at the Guardian's Office who gave the order to the adherents of the Church, who actually carried out the order, is not a representative of the Church. The analysis offered by the Court of Appeal glosses over this particular point. Whether this same judicial analysis would necessarily hold under Bill C-45 is an open question left for another day.

10.5 Law Reform: Can This Be Fixed?

The short answer to this question is "Yes". The question that remains is how this is to be done. The first option is to add the term "partner" to the definition of "senior officer", in much the same way that the definition already includes a director, a chief executive officer and a chief financial officer. The advantage of this approach is somewhat apparent. First, it fits within the current statutory scheme, in that one need only (1) remove the specific inclusion of a partner as a "representative" of the organization; and (2) add a specific inclusion of a partner as a "senior officer". Second, this solution goes no further than absolutely necessary to deal with the strategic planning opportunity. In other words, the solution is tailored to the specific matter at issue.

While this approach does have its advantages, there is an alternative. The second option is to amend the part of the definition of "senior officer" prior to the specific inclusions. For ease of reference, that portion of the definition reads as follows:

> "senior officer" means a representative who plays an important role in the establishment of an organization's policies or is responsible for managing an important aspect of the organization's activities [. . .][77]

The alternative approach would be to have this read as follows: "'senior officer' means (1) a representative who plays an important role in the establishment of an organization's policies or is responsible for managing an important aspect of the organization's activities; or (2) a person who, by virtue of his or her relationship to the organization, has the ability to play such a role whether or not the person chooses to do so. . .".[78]

The advantage of this alternative approach would be that it would not only catch partners (our immediate issue), but could include others, such as shareholders who have the ability to elect the board of directors.[79] This would ensure that those who have the ability to influence the decisions of others in management are held accountable. Put another way, the statute catches those making decisions, but not the puppeteer "pulling the strings" who, if he or she does not like the decisions of management, has the ability to simply change the management team so as to comply with this person's wishes. This alternative suggestion is a more far-reaching change to the statute, and not as focused on the issue at hand.

Although my personal inclination with respect to law reform is generally to be aggressive in the suggestions I put forward, this case provides an exception to this rule. The second more far-reaching approach may have certain unforeseen,

[77] *Code* (n 20) s. 2, "senior officer".

[78] While the opening words of the definition of "senior officer" and potential revision of those words are offered here, it is not designed to eliminate the specific inclusions that are not reproduced here.

[79] For an example of how a similar process is used in the law of income tax particularly with respect to the issue of corporate control, see *Buckerfield's Ltd. v. Minister of National Revenue* [1965] 1 Ex. C. R. 299.

unintended, and negative consequences. These potential consequences are worthy of study and consideration by scholars, policy analysts, and legislators. Nonetheless, making a legislative change without having at least considered the potential consequences of the change would be somewhat ill-advised. Therefore, my two contentions are as follows: First, the statute should be amended to make partners "senior officers" of the partnerships to which they belong. Second, some additional research should be done to determine whether a more aggressive change to the statutory language would have unacceptable consequences. If not, then legislators might consider a second amendment to the language to adopt the stronger stance. If, on the other hand, negative consequences were likely as a result of the stronger language, then no further change would be advisable.

10.6 Conclusion

In the end, the analysis provided herein is meant to show that in passing Bill C-45, the Canadian Parliament created an opportunity for strategic planning that was not originally intended by the government, according to its own Backgrounder on the Bill. Furthermore, other areas of law, namely principles of law drawn from agency, fiduciary and partnership law, criminal law generally, and the law of corporate criminal liability in particular, do not support the provision of the opportunity for strategic planning. If this analysis is sound, then the question becomes how to change the statute to close down the unintended opportunity for strategic planning. There is a narrower option to solve this issue, as well as a more aggressive approach. While each has its merits, the more cautious approach is to be preferred. The next step is up to the legislature. Will there be the political will to close the loophole? If so, will the legislature take the cautious approach, or the aggressive one? These questions cannot be meaningfully answered here. But, it is nonetheless interesting and important to recognise that an appreciation of the reality of a strategic approach to law can lead to illuminating issues which might otherwise go without comment.

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Chapter 11
Corporate Risk Management and Legal Strategy

Alice Belcher

Abstract The board of directors has ultimate responsibility for strategies implemented by corporations. This chapter provides a link between the board's risk management activities and corporate legal strategies. In this context, there are two relevant regulatory elements: the corporate governance rules that require companies to establish a risk management policy and the associated disclosure, and the specific legal requirements that the particular company risks breaching due to the nature of its operations. The theoretical part of the chapter examines the concept of strategy and explores the connections and tensions between corporate risk management policy, the expectations generated by risk management disclosures, the company's true exposure to legal risks, and the implications for enterprise.

The chapter then shifts focus to look at a number of examples that reveal the problems associated with treating the law as fixed. Examples include: the introduction of new statutory law where the company's ability to generate and preserve useful evidence may become an issue (e.g. *Corporate Manslaughter and Corporate Homicide Act 2007*, UK); established statutory duties where a degree of uncertainty remains due to difficulties in statutory interpretation (e.g. aspects of United Kingdom health and safety law); and established law that becomes subject to change in a common law system (e.g. the duty of care to those injured on company premises). These examples are linked back to the opening discussion of corporate governance principles with the aim of highlighting difficulties and inconsistencies faced by a board in coping with both its governance role and its role in corporate legal strategy.

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11.1 Introduction

The board of directors has ultimate responsibility for strategies implemented by corporations. This chapter will provide a link between the board's risk management activities and corporate legal strategies. In this context, there are two relevant regulatory elements: the corporate governance rules that require companies to establish a risk management policy and the associated disclosure, and the specific legal requirements that the particular company risks breaching due to the nature of its operations. When Dulewicz and Herbert conducted a study of the priorities of United Kingdom (UK) boards they stated:

> The single most compelling finding of this study is the importance and effort which boards attach to fulfilling their legal and fiduciary duties in whatever sphere they arise. ... Far from nurturing a spirit of enterprise in which the board's principal concern is with value-adding endeavour, they have been pre-occupied with matters of disclosure and compliance.[1]

The theoretical part of the chapter examines the connections and tensions between corporate risk management policy, the expectations generated by risk management disclosures, the company's true exposure to legal risks; and the implications for enterprise.

The chapter then shifts its focus to look at a number of examples that reveal the problems associated with treating the law as fixed or even known. This part of the chapter uses UK law, but it is hoped that its general ideas will travel beyond its specific settings. Examples include: the introduction of new statutory law where the company's ability to generate and preserve useful evidence may become an issue (e.g. *Corporate Manslaughter and Corporate Homicide Act 2007*, UK); established statutory duties where a degree of uncertainty remains due to difficulties in statutory interpretation (e.g. aspects of UK health and safety law); and established law that becomes subject to change in a common law system (e.g. the duty of care to those injured on company premises). These examples are linked back to the opening discussion of corporate governance principles with the aim of highlighting difficulties and inconsistencies faced by a board in coping with both its governance role and its role in corporate legal strategy. However, before addressing the main theme of risk, the concept of strategy will first be considered.

11.2 Strategy

In this preliminary discussion of strategy it is, of course, impossible to cover the subject in detail. The aims are: to explain different theoretical approaches to

[1] V. Dulewicz, and P. Herbert "The Priorities and Performance of Boards in UK Public Companies" (1999) 7(2) Corporate Governance: An International Review 188.

corporate strategy; to consider what legal strategy might consist of; and to demonstrate how corporate and legal strategies can become entangled.

11.2.1 Corporate Strategy

There is a vast amount of literature (positive, normative and polemical) on corporate strategy. Academic approaches to, or perspectives on, strategy can be mapped – in true Management style – on a 2 × 2 matrix where outcomes can be profit-maximising or plural on one axis and where processes can be deliberate or emergent on the other axis.[2] The four possible outcomes of this mapping are the "Classical", "Evolutionary", "Processionalist" and "Systemic" approaches to corporate strategy.[3]

It is useful to set out the basic assumptions behind these four approaches because they result in different views of strategy's ability to respond to or change the external environment. The potential role legal strategy plays as part of corporate strategy can also be examined under the lens of each approach. The Classical approach to strategy is described by Whittington as follows:

> . . . a rational process of deliberate calculation and analysis designed to maximise long term advantage. If the effort is taken to gather the information and apply the appropriate techniques, both *the outside world* and the organization itself can be made predictable and plastic, shaped according to the careful plans of top management. For the Classicists, good planning is what it takes to master internal and *external environments*.[4]

In terms of the 2 × 2 matrix the Classical position combines a profit-maximising outcome with a deliberate process. The key features of the Classical approach are the attachment to rational analysis, the separation of conception from execution, and the commitment to profit maximisation.[5] Techniques for arriving at a profit-maximising strategy often involve formulating the consequences of the company's endogenous activities and maximising the resultant profit subject to its exogenous constraints. This practice has historically, and in the majority of management accounting textbooks, seen most of the environment outside the company as exogenous, i.e. a set of fixed or given constraints. The law, if it considered at all in these models, is seen as a constraint, not as something capable of being moved or influenced by the company. For corporate legal strategy to be placed into the classical model, the legal strategy must be part of an overall profit-maximising strategy, and the law must be included in the model as a part of the outside world that is plastic.

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[2]R. Whittington, *What is Strategy and Does It Matter?*2nd ed. (Thomson Learning, 2001) 10 [Whittington].

[3]Whittington frames these four approaches in terms of four combinations of ways in which the two questions of his book title can be answered, i.e. What is strategy? And does it matter? ibid.

[4]Ibid 2–3, emphasis added.

[5]Ibid 11.

In the Evolutionary approach, the outcome continues to be profit-maximising, but the process is emergent rather than deliberate. Whittington provides the following description of corporate activity in this quadrant of the 2 × 2 matrix:

> The environment is typically too implacable, too unpredictable to anticipate effectively. . . .The dynamic, hostile and competitive nature of markets means naturally that long-term survival cannot be planned for; it also ensures that only those firms that somehow do hit upon profit-maximizing strategies will survive. Businesses are like the species of biological evolution; competitive processes ruthlessly select out the fittest for survival; the others are powerless to change themselves quickly enough to ward off extinction. . . . All managers can do is ensure that they fit as efficiently as possible to the environmental demands of the day.[6]

The environment, including the legal environment, is seen as putting demands on companies and only those that "hit upon" a good fit will survive. This is an extremely pessimistic view and one in which good management decisions appear to be a matter of chance. In this version, the unit of analysis is the company, and only companies that produce useful mutations survive. However, Nelson and Winter, the economists credited with inventing the Evolutionary theory of the firm, use routines within the firm as the unit of analysis and have mutations in these routines competing for survival.[7] This allows management decisions that promote or restrict mutations in corporate routines to make a difference, and reinstates the possibility of good management as more than chance. However, even in the more optimistic version of the Evolutionary approach, there is little room for managers to adopt a particular corporate legal strategy. As with other areas of the business, under this approach the most effective tactic may be to experiment with many small initiatives and see which flourish.

According to the Processualists:

> . . . people are too different in their interests, limited in their understanding, wandering in their attention, and careless in their actions to unite around and then carry through a perfectly calculated plan. Anyway, the plan is bound to get forgotten as circumstances change. In practice, strategy emerges more from a pragmatic process of bodging, learning and compromise than from a rational series of grand leaps forward.[8]

However, because this approach moves away from profit-maximisation and allows for companies with plural outcomes to survive, it does not matter if the emergent strategy is not quite optimal. Under the Processual approach, processes are emergent and outcomes are plural. Processual theories are also linked with the resource-based view of the firm:

> In the resource-based view, the firm is seen as a bundle of resources and comparative advantage is explained by the possession of a bundle with particularly valuable attributes. Resources are posited to be particularly valuable if they are rare and hard to imitate. This has meant that: 'most interest has centred on internally accumulated resources, such as

[6]Ibid.

[7]R. R. Nelson, and S. G. Winter, *An Evolutionary Theory of Economic Change* (Harvard University Press, 1982).

[8]Whittington (n 2) 2–3.

> routines and capabilities, rather than those that can be purchased on factor markets.'[9] This centering on knowledge and skills as key resources focuses the resource-based view of the firm down into the more specific knowledge-based approach.[10]

Corporate strategies under this approach therefore focus on the internal. Law, which affects this company and its competitors equally, cannot be the source of a comparative advantage.

Finally, Systemic theorists consider processes to be deliberate but outcomes to be plural. They maintain that people do have the capacity to conceive and carry out rational plans of action (like the Classicists), but that social systems and cultures mean that competitive pressures do not always dominate (unlike the Classicists):

> ... markets can be manipulated or bamboozled and societies have other criteria for supporting enterprises than just financial performance. The systemic approach, therefore, believes that strategy reflects the particular social systems in which strategists participate defining for them the interests in which they act and the rules by which they survive.[11]

In this approach, the law is again outside the company and exogenous. It can be different in different locations and should be factored into deliberate decision-making, but normally (as under the Classical approach) as a constraint.

The four-fold classification of corporate strategic thought as set out above is fairly well accepted in the management literature as a way of capturing relatively simply, the work of a host of theorists. However, one further specific model is worth mentioning in the context of corporate legal strategy. Bougon and Komocar suggested a "dynamic wholistic approach" in which "loops create organizations". This sounds extremely abstract, but it explicitly allows for feedback loops between elements that are traditionally inside and outside the boundaries of firms. The approach relieves a strategist from several conceptual difficulties including "the split between participants, organizations and environments".[12]

11.2.2 Legal Strategy

Having discussed corporate strategy without referring specifically to any particular legal strategies, this sub-section moves on to consider a particular legal strategy in isolation from the company. The most obvious place to see legal strategy is in campaigns. Examples could include the abolition of slavery, voting rights for

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[9]K. Foss, and N. Foss "The Knowledge-Based Approach and Organizational Economics", N. Foss, and V. Mahnke eds., *Competence, Governance, and Entrepreneurship* (Oxford University Press, 2000) 65.

[10]A. Belcher, and T. Naruisch "The Evolution of Business Knowledge in the Context of Unitary and Two-tier Board Structures" (July, 2005) Journal of Business Law 443–472.

[11]Whittington (n 2) 2–3.

[12]M. G. Bougon, and J. M. Komocar, "Directing Strategic Change: A Dynamic Wholistic Approach", A. S. Huff ed., *Mapping Strategic Thought* (John Wiley & Sons, 1990) 158.

women, and the banning of fox hunting. However, one of the most celebrated campaigns of this sort succeeded in changing the law through the use of litigation, namely, the end of segregation in the United States' public education system on the basis of colour. According to Tushnet:

> Most commentators on the NAACP's [National Association for the Advancement of Colored People] litigation have seen the campaign as a combination of strategic planning and successful implementation. Because the NAACP's litigation ended so spectacularly with the decision in *Brown,*[13] it has been hard to resist two temptations: the first is to see the outcome as the obvious product of plans that had been laid many years before, and the other is to take the campaign as a model for public interest law generally.[14]

The first temptation can be mapped onto the divide between two sides of the corporate strategy matrix – the deliberate and emergent positions. It is important to notice how it is the combination of hindsight and an ultimately successful campaign that allows commentators to construct the campaign strategy as planned and deliberate. Also, it is worth noting that the use of the word "plan" does not of itself position the NAACP's approach on the "deliberate" side of the matrix. Tushnet considers that many commentators:

> . . . seriously overestimate deliberate design as a characteristic of the NAACP campaign . . .[Because] participants repeatedly characterized their efforts as the execution of a plan, but the contents of the "plan" changed with some frequency.[15]

The particular legal strategy of the NAACP was to use litigation to effect both legal and social change. However, the sequence of the plan then executed can only be seen in hindsight.

11.2.3 The Entanglement of Corporate and Legal Strategy

Explanations of corporate strategy have in the past tended to place the law in the company's environment and to consider it as either: a constraint (Classical approach); part of survival of the fittest and not controllable (Evolutionary approach); as relatively unimportant because as externally generated, it cannot be a source of comparative advantage (Processual approach); or as part of the local environment (Systemic approach). The title of this volume is, in itself, a claim that corporate legal strategies are possible, but it leaves open the question of whether they are best modelled as deliberate or as emergent. One well-known example of

[13]In *Brown v. Board of Education*, (1954) 347 U.S. 483 (USSC) the US Supreme Court held that "separate but equal" has no place in public education and separate educational facilities for blacks and whites are inherently unequal.

[14]M. V. Tushnet, *The NAACP's Legal Strategy against Segregated Education, 1925–1950* (University of North Carolina Press, 1987) 144.

[15]Ibid.

legal pressure influencing corporate strategy, is the break up of the US telecommunications group AT&T. Beginning in the 1960s, the Federal Communications Commission gradually allowed entry of new competitors into industry sectors historically occupied by AT&T as a regulated monopoly. AT&T allegedly responded with measures designed to stem the growth in competition, and in 1974, the Department of Justice (DOJ) filed an antitrust suit against AT&T. This suit finally ended in 1982 when AT&T accepted a Consent Decree offered by the DOJ. On the one hand this was described as "a complete victory for the Department of Justice"[16] on the other hand it was reported:

> In a strategic shift more daring than anyone ever thought could come from the telephone company, Bell [one of AT&T's names] decided to give up its monopoly in the standard telephone business by agreeing with the Department of Justice to divest its 22 local operating companies.[17]

Fletcher and Huff studied AT&T documents for the period 1973–1983 in order to map how the company was constructing strategic arguments over the period and how these arguments changed. They found that AT&T's views on industry structure went through a transformation beginning with a period of strong defence of the traditional monopoly structure, through a period where new requirements were being anticipated, to acceptance of the Consent Decree and finally divestment involving a complete restructuring of AT&T itself. Fletcher and Huff also note that for the seven-year duration of the antitrust suit, AT&T faced numerous uncertainties created by other regulatory, legislative and judicial activities. This is a story that can be told in terms of the company experiencing a changed legal environment that imposed new constraints. It can also be told as the story of a company's emergent corporate legal strategy.

This brief discussion of strategy allows two points to be made. Both are points of caution. First, it is clear that even in the crudest, four-fold classification of strategic thought there is a huge range of underlying assumptions that can be made about what strategy is and how important it can be. Second, it is apparent from the AT&T story that a set of facts can become a story of the legal constraint of a company, or of the company's development of a daring legal and corporate strategy.

11.3 Risk Management and Corporate Governance

The requirements for UK listed companies to formulate risk management policies and to report to shareholders that they have done so, arise out of the "internal

[16]K. E. Fletcher, and A. S. Huff, "Strategic Argument Mapping: A Study of Strategy Reformulation at AT&T", A. S. Huff ed., *Mapping Strategic Thought* (John Wiley & Sons, 1990) 169 [Fletcher and Huff].

[17]*Business Week*, (11 October 1982) cited in Fletcher and Huff, ibid.

control" provision of the UK's *Combined Code on Corporate Governance* (the *Combined Code*) which states:

> The directors should, at least annually, conduct a review of the effectiveness of the group's system of internal control and should report to shareholders that they have done so. The review should cover all controls, including financial, operational and compliance controls and risk management.[18]

According to Power, this provision "...generated fundamental problems about what internal controls really are and what one is saying in describing them as effective".[19] In 1992, when the provision first appeared in the *Code*,[20] the non-financial (or the not directly financial) aspects of the provision were new and difficult for both company directors and auditors. Under the Rutteman Guidance,[21] the initial response to the provision, directors were able to restrict their confirmation of their review of the effectiveness of the system of internal control to internal *financial* control. However, it was recognised that a partial implementation of the *Combined Code* could only be sustained in the short term. Conceptually, "internal control" moved beyond "internal financial control". For instance, in a survey of large UK companies conducted in 1994/1995, 76.9% of the finance directors who responded thought that internal controls should not be restricted to financial controls but should be considered in their widest sense.[22] This might be seen as an emergent strategic response endorsing the implementation of a new code provision, or it could be seen as a resigned approach to the forced implementation of an unwelcome code provision. Just as the AT&T story can be told as one of legal strategy or of capitulation, so too can the story of the internal control provision.

Full implementation of the internal control provision was delayed until guidance was provided to directors in the form of *Internal Control: Guidance for Directors on the Combined Code* (the Turnbull Guidance), published in April 1999.[23] The London Stock Exchange rules were adjusted to require full compliance with the *Combined Code* for all accounting periods ending on or after 23 December 2000.

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[18]See provision D.2.1 of the *Combined Code on Corporate Governance,* (1998) [The Code]. The *Code* was first published in June 1998 and fully effective on or after 22 December 2000. The new *Combined Code* was published 2003, online: FSA http://www.fsa.gov.uk/pubs/ukla/lr_comcode2003.pdf.

[19]M. Power, *The Audit Society: Rituals of Verification* (Oxford University Press, 1997) 55.

[20]At that time referred to as the *Cadbury Code of Best Practice*.

[21]UK, Rutteman Working Group, *Internal Control and Financial Reporting – Guidance for directors of listed companies registered in the UK* (ICAEW, 1994) [the Rutteman Guidance].

[22]R. W. Mills, "Internal Control Practices within Large UK Companies", K. Keasey, and M. Wright eds., *Corporate Governance: Responsibilities, Risks and Remuneration* (John Wiley & Sons, 1997).

[23]The Turnbull working party, *Internal Control: Guidance for Directors on the Combined Code* (ICAEW, 1999) [The Turnbull Guidance] and revised version (FRC, June 2005), online: FRC http://www.frc.org.uk/documents/pagemanager/frc/Revised%20Turnbull%20Guidance%20October%202005.pdf.

These rules are now overseen by the Financial Reporting Council (FRC). The Turnbull Guidance itself emphasises the wide scope of the *Combined Code* provision. It states: ". . .internal controls considered by the board should include all types of controls including those of an operational and compliance nature, as well as internal financial controls".[24] The significant issue for the Turnbull Working Party was not *whether*, but *how* directors were to deal with the whole of the internal control provision of the *Combined Code*, and in particular the issue of effectiveness.[25] The answer they provided was the "risk-based approach". The Turnbull Guidance states:

> A company's objectives, its internal organisation and the environment in which it operates are continually evolving and, as a result, the risks it faces are continually changing. A sound system of internal control therefore depends on a thorough and regular evaluation of the nature and extent of the risks to which the company is exposed. Since profits are, in part, the reward for successful risk-taking in business, the purpose of internal control is to help manage and control risk appropriately rather than eliminate it.[26]

The Turnbull Guidance also states that: "Significant risks may, for example, include those related to market, credit, liquidity, technological, *legal,* health, safety and environmental, reputation, and business probity issues".[27]

In order to implement the Turnbull Guidance, UK listed companies needed to work out the meaning of a risk-based approach application and its limitations. Across companies, the answers can be different. Turnbull states that each board must "ensure that the system of internal control is effective in *managing those risks in the manner which it has approved*".[28] Further, it has been described as a framework rather than a rulebook. The aim was to promote a bespoke rather than an off-the-peg approach to risk management.[29] However, the Guidance is "based on the adoption by a company's board of a risk-based approach to establishing a sound system of internal control and reviewing its effectiveness".[30] This involves the identification and prioritising of risks and embedding the risk management approach in the culture and processes of the business. The process envisaged by

[24]Ibid para. 28.

[25]A review of the continued appropriateness of the Turnbull Guidance published by the Financial Reporting Council in June 2005 confirmed that "The guidance should continue to cover all internal controls", and not be limited to internal controls over financial reporting. Overall, the Review concluded that significant changes are not required. See, Financial Reporting Council, Turnbull Review Group, "Review of the Turnbull Guidance on Internal Control" (16 June 2005), online: FRC http://www.frc.org.uk/documents/pagemanager/frc/Turnbull%20review%20evidence%20paper.pdf [FRC Review of the Turnbull Guidance].

[26]The Turnbull Guidance (n 23) para. 13.

[27]Ibid Appendix, emphasis added.

[28]Ibid para. 16, emphasis added.

[29]A. Carey, and N. Turnbull, "The Boardroom Imperative on Internal Control", J. Pickford ed., *Mastering Risk* (Pearson Education Ltd., 1999) 6.

[30]The Turnbull Guidance (n 23) para. 9.

Turnbull is that the board should, in the light of the company's business objectives, set policies on internal control through a consideration of:

> the nature and extent of the risks facing the company; the extent and categories of risk which it regards as acceptable for the company to bear; the likelihood of the risks concerned materialising; the company's ability to reduce the incidence and impact on the business of risks that do materialise; and the costs of operating particular controls relative to the benefit thereby obtained in managing the related risks.[31]

Management should implement these policies, but all employees are seen as having some responsibility for internal control as part of their accountability for achieving objectives. Boards should ask: "Does the company communicate to its employees what is expected of them and the scope of their freedom to act?"[32] The process of changing behaviour at all levels of the company is described as "embedding" the implementation of Turnbull. Turnbull emphasises behaviour and conduct. Jones and Sutherland use the phrase "emphasis on changing *behaviour*".[33]

In the UK, the *Combined Code*[34] operates on a "comply or explain" basis where companies must either report compliance with the code or disclose the ways in which they do not comply along with their reasons for non-compliance. Companies can fully comply with the internal control provision of the code by adopting and implementing a risk management policy. They do not have to disclose the nature of that policy; it is enough that the company simply has one.[35] It does not follow automatically that when boards are required to have a risk management policy that the chosen policy will align company decisions with legally acceptable decisions in any resulting court case. Risk management policy becomes inextricably entangled with the estimation and management of legal risks.

Just as there are theoretical questions about the extent to which strategy can be planned and deliberate, there are issues associated with risk management, in particular, problems concerned with framing risks appropriately, self-serving biases in risk estimation, and whether the technique is appropriate at all if the situation is better characterised as uncertain rather than risky.[36] The association of risk taking

[31]Ibid para. 17.

[32]Ibid Appendix.

[33]M. E. Jones, and G. Sutherland *Implementing Turnbull: A Boardroom Briefing* (ICAEW, 1999) 21, online: ICAEW http://www.icaew.com/index.cfm/route/120932/icaew_ga/pdf.

[34]See (n 19) and associated text.

[35]The FRC Review of the Turnbull Guidance (n 25) encourages boards to include in the internal control disclosure such information as is considered necessary to assist shareholders' understanding of the main features of the company's risk management processes and system of internal control.

[36]A. Belcher, "'Something distinctly not of this character': how Knightian uncertainty is relevant to corporate governance" (2008) 28(1) Legal Studies 46–67.

with enterprise should also be noted. The law is often there to draw a line between acceptable and unacceptable risk-taking in the pursuit of profit. In this context, the Court of Appeal ruling on aggravating factors in breaches of Health and Safety law is worth noting:

> Particular aggravating features will include (1) a failure to heed warnings and (2) where the defendant has deliberately profited financially from a failure to take necessary health and safety steps, or specifically *run a risk* to save money.[37]

A significant problem with the risk-based approach to the internal control provision is that the reporting to the shareholders may be misread. A shareholder, seeing that the company has a risk management policy, may think that this is a risk reduction or minimisation policy, but it need not be. Indeed, the relationship between risk and return suggests that high returns are associated with high risks, so maximising shareholder returns inevitably means *taking* risks – although these need not be legally unacceptable risks.

The estimation of the legal risks run by a company is not simple. Risks include the risk of non-compliance (even when the company intends to comply), the risk of an unfavourable incident, and the range of potential reputational (e.g. bad press) and financial (e.g. fines) consequences. Estimating the risk of non-compliance is made more difficult when: the law is new so the courts have not yet ruled on the sort of evidence that will be taken to indicate compliance;[38] when the law is older but has not yet been interpreted in the highest court;[39] and when the law is subject to change.[40] The next section of the chapter provides examples of these three problems.

Following the publication of the Turnbull Guidance there has been a general acceptance of its approach across many companies and other sorts of organization. Risk registers and the four-fold classification of risks in a matrix format (more or less likely to happen and mapped against large or small impact) are now familiar and expected features of governance systems. To the extent that risk management is designed to minimise the risk of non-compliance, minimise risk of large legal payouts, or minimise the reputational damage arising from prosecutions or unfavourable lawsuits, it can be thought of as part of the company's legal strategy.

11.4 Recent UK Legal Developments

In this section of the chapter, three UK examples of difficulties in estimating legal risks are set out. If legal strategy, in the form of using or influencing the law,

[37]R v. F. Howe & Son [1999] 2 All ER 249, [1999] IRLR 434 (C.A.) 437, emphasis added.

[38]See for example the *Corporate Manslaughter and Corporate Homicide Act 2007* (C.19).

[39]See for example, UK law on protective clothing.

[40]See for example, UK law on occupiers' duty to protect against risks.

requires knowledge of the current position of the company in relation to the law, estimation of legal risks becomes a prerequisite for a coherent strategy.

11.4.1 Corporate Manslaughter and Corporate Homicide Act 2007

This statute introduced a new offence of Corporate Manslaughter in England and Wales and a new offence of Corporate Homicide in Scotland. The basic elements of the two offences in the *Act* are the same. As described by the Explanatory Notes:

- The organisation must owe a duty of care to the victim that is connected with certain things done by the organisation . . .
- The organisation must be in breach of that duty of care as a result of the way in which certain activities of the organisation were managed or organised by its senior managers. *This introduces an element of "senior management failure" into the offence. . .*
- This management failure must have caused the victim's death. The usual principles of causation in the criminal law will apply to determine this question . . .
- The breach of duty must have been gross . . . The test asks whether the conduct that constitutes the failure falls far below what could reasonably have been expected . . . Clause 9 [now clause 8 of the Bill] sets out a number of factors for the jury to take into account when considering this issue. There is no question of liability where the management of an activity includes reasonable safeguards and a death nonetheless occurs".[41]

The Explanatory Notes go on to say that senior management failure:

> . . . looks at how in practice managers organised the performance of a particular activity, rather than focusing on questions of individual culpability, and *enables management conduct to be considered collectively* as well as individually.[42]

The most important change in legal thinking is that this will enable management conduct to be considered collectively as well as individually. The new offences are already being described in terms of "senior management failure". So long as the emphasis remains on "management" failure as a failure to manage properly and does not become "senior management" failure which could drift into meaning the failure of a senior manager, the collective aspect of the offences should be preserved. Also section 8 of the *Act* explicitly permits the jury to:

> (3) . . . (a) consider the extent to which the evidence shows that there were attitudes, policies, systems or accepted practices within the organisation that were likely to have encouraged any such failure as is mentioned in subsection (2), or to have produced tolerance of it; [and] . . .
> (4) This section does not prevent the jury from having regard to any other matters they consider relevant.

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[41] *Corporate Manslaughter and Corporate Homicide Bill, Explanatory Notes,* (21 July 2006) para. 14, emphasis added, online: House of Commons – Explanatory Note http://www.parliament.the-stationery-office.co.uk/pa/cm200506/cmbills/220/en/06220x–.htm.

[42] Ibid para. 15, emphasis added.

This is the place where the *Corporate Manslaughter and Corporate Homicide Act 2007* is closest to the framing of corporate criminal responsibility under the Australian *Criminal Code Act 1995*. The Australian statute provides that a company is responsible when a corporate culture existed within the body corporate that directed, encouraged, tolerated or led to non-compliance with the relevant provision. "Corporate culture" is defined as "an attitude, policy, rule, course of conduct or practice existing within the body corporate generally or in the part of the body corporate in which the relevant activities take place".[43] The relevant Criminal Code provision is Australian *Criminal Code Act 1995* part 2.4, section 12.3. The explanatory memorandum to this provision states that it will allow:

> the prosecution to lead evidence that the company's written rules tacitly authorised non-compliance or failed to create a culture of compliance. It would catch situations where, despite formal documents appearing to require compliance, the reality was that non-compliance was expected. For example, employees who know that if they do not break the law to meet production schedules (for example, by removing safety guards or equipment), they will be dismissed. The company would be guilty of intentionally breaching safety legislation. Similarly, the corporate culture may tacitly authorise reckless offending (for example, recklessly disregarding the substantial and unjustifiable risk of causing serious injury by removing the equipment guards). The company would be guilty of a reckless endangerment offence.[44]

In England and Wales and in Scotland, the offences of corporate manslaughter and corporate homicide respectively will also attribute criminal responsibility to companies on the basis of collective management failure which can be evidenced by failures of corporate culture. In Australia, corporate criminal responsibility has been codified in Commonwealth legislation, but the codified method of attributing criminal responsibility only applies directly to federal level crimes. The position within individual states varies. So, for instance, in Australian Capital Territory (ACT), the enactment of Part 2.5 of the *Criminal Code Act 2002* (ACT) brought the *Criminal Code Act 1995* (Cth) into ACT law. Other Australian states have approached the issue in various ways and with different degrees of success.[45] No prosecutions have yet been reported that employ Australia's "corporate culture" provisions to attribute corporate criminal responsibility.

To comply fully with the Turnbull Guidance, boards need not only to have a risk management policy, but must also ensure that the policy is embedded in corporate behaviour and corporate culture. Further, to ensure that the company is not found criminally culpable for a death, boards need not only to have relevant health and

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[43] *Australian Criminal Code Act 1995* (Cth), part 2.4, section 12.3(6).

[44] *Explanatory Memorandum to the Criminal Code Bill 1994* (Cth) para. 7.126.

[45] Australia, *Workplace Death and Serious Injury: a Snapshot of Legislative Developments in Australia and Overseas*, Research Brief No. 7 (2004–2005), online: Parliament of Australia, Parliamentary Library http://www.aph.gov.au/library/Pubs/rb/2004–05/05rb07.htm. The story of Victoria's attempts to legislate in this area has been told in Karen Wheelwright, "Corporate Liability For Workplace Deaths And Injuries – Reflecting On Victoria's Laws In The Light Of The Esso Longford Explosion" (2002) 7(2) Deakin Law Review 348.

safety policies, but must also ensure that corporate behaviour and corporate culture are in line with those policies. At a time when the language of corporate criminal culpability is emphasising conduct and culture, the language of the Turnbull Guidance is emphasising embedding and behaviour. The two developments at least appear to be moving in the same direction, however it has already been noted that compliance with the Turnbull Guidance does not necessarily mean compliance with the law. The risk of failing to comply with the new statute is difficult to estimate because corporate culture is difficult to assess and evidence of it difficult to decide upon.

11.4.2 Health and Safety Law

In the UK there is a general requirement for "suitable and sufficient" risk assessments to be carried out in Regulation 3(1) of the *Management of Health and Safety at Work Regulations 1999*.[46] Section 15 of the *Health and Safety at Work, etc., Act 1974* gives the Secretary of State power to make regulations called "health and safety regulations" and it is an offence to contravene any such regulations.[47] Thus, a failure to conduct a risk assessment as required under the regulations is in itself an offence. When the requirement for risk assessments was first introduced, the Health and Safety Executive produced guidance on what was expected. The elements of a risk assessment were set out as: identification of all the hazards; measurement of the risks; evaluation of the risks; and implementation of measures to eliminate or control the risks. However, the early guidance was reviewed and withdrawn according to the HSE because:

> In both content and layout, we believe this publication sends entirely the wrong message – that risk assessments are complicated procedures requiring much effort, form filling and analysis. Discussions with operational colleagues and stakeholders indicate that publications like "5 steps to risk assessment" are much more accessible and likely to get action in practice.

The HSE leaflet, *Five steps to risk assessment,* is aimed at small employers and offers the following guidance on how to assess risks in the workplace:

> Follow the five steps in this leaflet:
>
> - Step 1: Identify the hazards
> - Step 2: Decide who might be harmed and how
> - Step 3: Evaluate the risks and decide on precaution
> - Step 4: Record your findings and implement them

[46]SI 1999/3242. These regulations replace the *Management of Health and Safety at Work Regulations 1992* SI1 1992/2051 that contained the earliest explicit requirement for a risk assessment to be carried out.

[47]*Health and Safety at Work, etc., Act 1974* (UK), 1974, s. 33(c).

- Step 5: Review your assessment and update if necessary

> Don't overcomplicate the process. In many organisations, the risks are well known and the necessary control measures are easy to apply. You probably already know whether, for example, you have employees who move heavy loads and so could harm their backs, or where people are most likely to slip or trip. If so, check that you have taken reasonable precautions to avoid injury.
>
> If you run a small organisation and you are confident you understand what's involved, you can do the assessment yourself. You don't have to be a health and safety expert.[48]

In addition to the general requirements for risk to be assessed, there are also many specific regulatory requirements relating for example to hazardous substances,[49] avian flu[50] and the risks to women of childbearing age.[51] Given the general and specific requirements for risk assessments to be conducted by a particular company, it can either comply or it can "run the risk" involved in either conducting no assessment or conducting an inadequate assessment.

Fytche v. Wincanton Logistics plc,[52] a recent case that reached the House of Lords, involved the general issue of risk assessment and protective clothing. The judgment in favour of the employer was by a majority of 3:2 and the crux of the matter was the framing of the risks involved. Fytche claimed against his employer for damages for personal injury caused by breach of the *Personal Protective Equipment at Work Regulations 1992*.[53] He had been supplied with a pair of steel toecap boots for protection against heavy weights that might fall on his feet in his job transporting milk churns – a risk that the employer did assess. The injury he sustained was frostbite caused when he attempted to dig his lorry out of snow and icy water entered his boot through a hole – a risk that the employer did not assess. If the employee could establish that the fault in the protective equipment was a regulatory breach, liability would follow. If the employee had to rely on the common law, he would have to establish all the elements of a negligence claim including foreseeability. There was no suggestion that the employer had been notified of the hole in the boot. The situation was well put in the dissenting judgment of Lord Hope:

> If the respondents [employers] are right, there is an absolute obligation on the employer under reg 7(1) to keep the equipment free from defects that may impair its efficiency as protection against the risks for the protection against which is was provided. But the obligation to keep the equipment free of other defects which may cause the employee to sustain injury at the place where he is exposed to those risks, such as the hole in the boot which caused Mr. Fytche's injury, is left to the common law. It is not suggested, of course, that there is no obligation to deal with any defects which may occur in the equipment. But it is said that the absolute obligation does not extend to other defects which the employer did

[48] UK, Health and Safety Executive, *Five steps to risk assessment* (2d ed.), (leaflet) (2006) INDG163REV2, online: HSE – Publications http://www.hse.gov.uk/pubns/indg163.pdf.

[49] *Control of Substances Hazardous to Health Regulations 2002*, SI 2002/2677.

[50] *Avian Influenza (Preventive Measures) (No 2) Regulations 2005*, SI 2005/3394I.

[51] *Management of Health and Safety at Work Regulations 1999,* SI 1999/3242.

[52] [2004] 4 All ER 221.

[53] SI 1992/2966, regs. 4, 7.

> not know about and of whose existence he could not have known about if he was taking reasonable care. On this view, the risk of injury due to defects of that kind rests not with the employer but with the employee.[54]

The judgment was in favour of the employers, the reasoning in the three majority judgments being very much in line with the above paragraph. Lord Hope, along with Baroness Hale took a different view. Baroness Hale's judgment tackles head on the problems arising out of assessing the wrong risks:

> But it does not mean that the extent of his liability under these regulations should be limited by the results of his own risk assessment. There is no civil liability for breach of the general obligation to assess risks: see the management regulations, reg 22. The employer may or may not have assessed the risks properly. He may or may not have identified the right risks. It would be odd indeed if an employer who had identified the wrong risks should be in a better position than an employer who had identified the right ones.[55]

This case arose out of a relatively simple set of circumstances. Its complications are all associated with legal technicalities concerning the fact that a breach of the *Personal Protective Equipment at Work Regulations 1992* can give rise to civil liability, but civil liability for a breach of the general obligation to assess workplace risks under the *Management of Health and Safety at Work Regulations 1999* is excluded by regulation 22. It is extremely unlikely that the employer's risk register would have listed the risk of liability for frostbite however, it is possible that it could have listed the risk of liability due to defective equipment. Risk managing the potential defective equipment liability would involve an inspection or reporting system for defects. Had a failure to manage boot defects resulted in a crushing injury, there is little doubt that the employer would have been liable. Because the failure to manage boot defects resulted in frostbite, they were not. However, with a system in place for reporting boot defects, an employee would be just as likely to report a hole as to report a problem with the steel toecap. This example reveals the difficulties of framing. The risk could be framed in terms of legal liabilities: risk of liability for regulatory breach, risk of liability in common law negligence, etc. The risk could also be framed in terms of injury to an employee: risk of foot injury, risk of crushing injury to foot, risk of frostbite in foot, etc. This illustrates another framing problem which probability theorists call the "breakdown of sample space". If the risk is framed in terms of foot injuries this encompasses both crushing and frostbite. However, the outcome "foot injury" can be broken down in many different ways, including crushing injury and frostbite and might be risk-managed differently depending on how this breakdown is done.

In a corporate governance setting, the drawing up of risk registers will be multi-dimensional. In line with the Turnbull Guidance, significant risks can include those related to market, credit, liquidity, technological, legal, health, safety and environmental, reputation, and business probity issues. For each of these headings, the company may have an existing system in place that has been dealing with risks

[54][2004] 4 All ER 230–231.

[55]Ibid 236.

within its narrow remit, for instance, a safety compliance programme. For some of these headings there are well-developed methods, terminologies and conventions with their own "professional" standards and literature. In the area of safety, the assessment of organizational safety climate and culture are current topics in the "safety science" literature.[56] The problem of framing has, of course, been acknowledged in these specialist risk management areas. So, for instance, institutionalised assumptions and norms that have the capacity to simultaneously illuminate some hazards while shifting attention away from others, have been described as a "fundamental paradox" of organizational safety culture.[57] "Avoiding disaster therefore involves an element of thinking both within administratively defined frames of reference (to deal with well-defined hazards that fall within an organization's prior worldview) and simultaneously stepping outside of those frames to at least consider the possibility of emergent or ill-defined hazards that have not been identified in advance (or which perhaps fall outside of an organization's strict administrative or legal remit)".[58] Whilst legal requirements to conduct risk assessments can be seen as encouraging organizations to imagine as many risks as possible, Pidgeon and O'Leary argue that it is all too easy for administratively defined frames to constrain thinking and fail to encourage those operating risk registers to "simultaneously step outside those frames". Estimating the legal risks associated with safety equipment management is clearly a difficult task as demonstrated by the close decision in *Fytche*. The two dissenting law lords would presumably have advised the company differently from the other three about its legal obligations and possible liability.

11.4.3 Borderlines in Occupiers' Liability Law

In *Young v. Kent CC*[59] a child fell through a skylight at a school. The claimant issued proceedings claiming, *inter alia*, that the authority had breached its duty under the *Occupiers' Liability Act 1984* – the Act which applies to those who are "trespassers" or "non-visitors" – by failing to provide adequate protection against foreseeable risks (the 1984 Act). The court held that:

[56]For examples of safety climate and culture see R. Flin, K. Mearns, P. O'Connor, and R. Bryden, "Measuring Safety Climate: Identifying the Common Features" (2000) 34 Safety Science 177–192; See also S. J. Cox, and A. J. T. Cheyne, "Assessing Safety Culture in Offshore Environments" (2000) 34 Safety Science 111–129. For organizational culture and climate see W. H. Glick, "Conceptualizing and Measuring Organizational and Psychological Climate: Pitfalls in Multilevel Research" (1985) 10(3) Academy of Management Review 601–616.

[57]N. Pidgeon, and M. O'Leary, "Man-Made Disasters: Why Technology and Organizations (Sometimes) Fail" (2000) 34 Safety Science 15–22, referring to N. F. Pidgeon, "Safety Culture: Key Theoretical Issues" (1998) 12(3) Work and Stress 202–216.

[58]Ibid.

[59][2005] EWHC 1342.

> . . . any school such as this one ought to have carried out a risk assessment of their premises and, if they had done so, they would have come to the conclusion that there was a risk of children getting onto the roof and suffering injury or death, and their failure to fence off the access point was negligent.[60]

The failure to carry out a risk assessment was therefore integral to the finding of negligence. It should, however, be pointed out that this decision has been described by the Court of Appeal as "borderline".[61] In order for an occupier to owe a duty to a non-visitor under the 1984 Act it must be shown that "the risk is one against which, in all the circumstances of the case, he may reasonably be expected to offer the other some protection".[62] Recent cases that have been held to fall on the other side of the borderline are *Tomlinson v. Congleton Borough Council*[63] and *Keown v. Coventry Healthcare NHS Trust*.[64] In *Tomlinson*, the Council were found not to be liable when an adult performed a dive into shallow murky water and suffered spinal injuries. Lord Hutton said: "I think the crucial question is whether Mr. Tomlinson has established that the risk was one to which s 1(3)(c) applies".[65] Having reviewed the authorities he concluded that ". . .the risk of Mr Tomlinson striking his head on the bottom of the lake was not one against which the council might reasonably have been expected to offer him some protection, and accordingly they are not liable to him because they owed him no duty".[66] In *Keown* an 11-year old fell having climbed up the outside of a fire escape. The National Health Service Trust was held not to be liable on the ground that there was nothing inherently dangerous about the fire escape and it must be shown that the premises were inherently dangerous. Longmore LJ stated, in obiter, that, in terms of the requirements of section 1(3)(c):

> . . . it would not be reasonable to expect a National Health Service Trust to offer protection from such a risk. If it had to offer protection from the risk of falling from a normal fire escape, it would presumably have to offer the same protection from falling from drain pipes, balconies, roofs . . ., windows and even trees in the grounds. This seems to me to be going too far.[67]

The risks to the occupier's business will include the risk of an injury being sustained on the premises (safety risk), the risk that the occupier is found liable (legal risk), which could itself depend on whether an appropriate risk assessment has been carried out, and the consequences for the business (reputational risk). This layering of risks has been described as risk assessment upon risk assessment. Again, corporate strategy becomes inextricably entangled with legal strategy.

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[60] Ibid para. 33.

[61] [2006] 1 WLR 958.

[62] *Occupiers' Liability Act 1984* (UK), s. 1(3)(c).

[63] [2004] 1 A.C. 46, [2003] 3 All ER 1122 [*Tomlinson*].

[64] [2006] 1 WLR 953 [*Keown*].

[65] *Tomlinson* (n 64) 87.

[66] Ibid 65.

[67] *Keown* (n 65) 959.

11.5 Conclusion

This chapter had the aim of linking legal strategy and risk management. A brief account was given of the conceptual difficulties in defining corporate strategy and legal strategy and the entanglement of the two. The place of risk management in current corporate governance best practice was set out. The chapter proceeded on the bases that: legal risks are covered by the risk-based approach of the Turnbull Guidance; legal risks may be extremely difficult to estimate; and an understanding of the company's current position in relation to the law is a prerequisite to forming a legal strategy aimed at either influencing or using the law. Three UK illustrations were given of the practical difficulties that can be encountered in estimating legal risk.

Chapter 12
A Legal Strategy Case Study: Trusts in Securitization

Darcy L. MacPherson

Abstract In this chapter, the author provides a case study to demonstrate how a trust can be used to alter the outcome of certain basic transactions. The particular focus of the case study is a securitization where a trust is used as part of a transaction to transform a secured borrowing into a transaction more advantageous for the corporate borrower. The essential elements of a securitization are first examined and compared with elements of the more traditional secured borrowing. This is followed by an examination from the perspective of "strategy" and explains how the use of the trust is designed to avoid the application of the legal rules that would otherwise apply to a borrowing and the consequences that would flow from such a borrowing transaction. The author then goes on to point out that, although the use of a trust may be strategic, it does not necessarily mean that negative results flow. Indeed, this particular strategy, in certain circumstances, can lead to advantages for parties other the initiator, such as creditors.

12.1 Introduction

In English law, the trust was one of the most distinctive legal tools created by the Court of Chancery whose task it was to administer the law of equity.[1] Although the exact origin of the trust is unclear, it seems to have evolved out of the legal structure known as a "use" where party A could transfer land, for example, to party B to hold for the use of C. Here, B was to hold the land for the benefit of C.[2] It appears that the earliest application of this structure was for the benefit of religious orders in that it

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[1]M. R. Gillen, and F. Woodman eds., *The Law of Trusts: A Contextual Approach* (Emond Montgomery Publications Ltd., 2000) 13.

[2]Ibid 18.

A. Masson and M.J. Shariff (eds.), *Legal Strategies*,
DOI 10.1007/978-3-642-02135-0_12,

enabled them to make use of and enjoy a piece of land despite an inability, by reason of their religious order, to own land.[3] Notwithstanding this seemingly noble origin however, it was not long before others realised that there were opportunities and advantages to be gained from such an arrangement, particularly those related to the avoidance of certain restrictions and taxation.[4]

In its most basic sense, therefore, the trust is a vehicle that separates legal ownership of the assets at issue from the beneficial ownership which belongs to a different party. In this paper we will look at a trust arrangement where the issuer trustee holds the limited partnership interest in trust for the investors who are the beneficiaries of the trust.[5]

The first suggestion herein, namely that a trust can be used as a vehicle to implement legal strategies, is fairly obvious. In fact, in the view of the author, it is beyond debate. However, the point of this contribution is *not* to extensively detail the use of the trust as a strategic tool. Rather, it is to develop one case study that uses the trust in order to demonstrate that strategy does not always imply negative consequences.

12.2 What Is a Securitization Transaction?

While there is no such thing as a "typical" securitization transaction, a securitization transaction could be structured as follows. First, there is a company that, for example, issues residential mortgage loans. But the company does not have sufficient liquid assets to issue all of the loans out of its own funds. In a more "traditional" approach to issuing the loans, the company itself would take out a loan from a bank of say $10 million, for example at 5%. Ordinarily, the bank would then take security over the assets of the company to protect its interests. The company would subsequently issue mortgage loans at 8.5%. The profitability of the company would depend on the "spread" on the loans of 3.5%. If the loans failed to perform, all the assets of the corporation would be at risk. To make the example a little more realistic, let us also assume that the corporation enters into another line of business (in addition to mortgage loans). Unfortunately, due to the fact that the bank has the first security interest over all assets of the company, further borrowing is difficult. Also, if the company encounters business difficulties unrelated to the mortgages, its creditors will all have to share in all the assets of the company.

In a securitization, the mortgage receivable is sold to a special-purpose vehicle. This will typically be a limited partnership. The originator of the mortgage receivable

[3]For further discussion on the use and conveyance of land to the town of Oxford for use of the Franciscan friars see ibid at 18.

[4]Ibid.

[5]At the request of the editors, this second contribution by the author has been written and included in this text to explore the trust as a legal strategy through reference to one case example.

(in this case, the company) accepts two things in return. The first is an amount of money equivalent to the face value of mortgage loans. The second is a limited partnership interest, which is essentially designed to compensate the originator for the interest that it would have earned on the mortgage loans.[6] With respect to the first item, the originator uses the funds to pay off the loan from the bank which provided the funds to make the mortgage loans in the first place. This means that after the limited partnership pays the originator for the mortgage receivable, in general, there is no bank loan still owing.

This arrangement of course, begs the question, from where does the limited partnership obtain the money to pay for the receivable? The answer is from limited partners, other than the originator. This is where the trust comes into the picture. One or more trusts are set up for the purpose of issuing debt securities to the public.[7] Calls are then made by the limited partnership on its limited partners, in accordance with both the partnership agreement and the declarations of trust which govern the relationship among the partners, on the one hand, and between the trustee and the beneficiaries, on the other. The trust then issues securities to investors.[8] The trust then uses the proceeds of the issuance of securities to pay for the call made by the limited partnership. Therefore, the money flows from the investors, to the trust, to the limited partnership, to the company, and then finally, to the bank. The bank loan is paid off. The limited partnership ends up with the mortgage receivable. The company ends up with a limited partnership interest and no debt. The debt is owed by the trust or trusts that have issued securities.

This in turn begs the next question of how the debt is to be repaid. In general, this is dealt with in the limited partnership agreement. As the money rolls in from the mortgagors, it goes to the limited partnership. When the partnership receives the payment from the mortgagor, the limited partnership pays this to the trust to the extent required to allow the trust to remain in good standing on its obligations to the holders of the securities.

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[6]For reasons that we will not go into in detail in this chapter, the originator should not be the general partner in the limited partnership. In order for the desired effect to occur, there must be financial separation between the originator on the one hand, and the partnership, on the other. If the originator were the general partner of the partnership, the required separation would not be achieved.

[7]As a business matter, more than one trust is often used in a securitization in order to issue securities with different maturity periods. For example, commercial paper securities (debt securities with maturity periods of less than a year) may be issued by one trust and longer-term notes (debt securities with maturity periods of a year or more) may be issued by another. In economic times where interest rates are increasing, longer-term notes may be issued to pay off maturing commercial paper. On the other hand, when interest rates are in decline, the issuance of commercial paper may be more advisable.

[8]While it is possible to issue securities to the public as part of this process, many originators prefer to reduce transaction costs by finding an investor to take a large block of the debt. A "sophisticated investor" exception (typically invoked by institutional investors and other persons of high wealth) reduces the disclosure obligations of the issuer. See M. G. Condon, A. L. Anand, and J. P. Sarra, *Securities Law in Canada: Cases and Commentary* (Emond Montgomery Publications Limited, 2005) 314–320.

A few points are critical here. First, for the effects described here to occur, the limited partnership must be considered separate from the originator, for financial purposes. Second, on a related point, for the securitization to be successful, the limited partnership must be "bankruptcy-remote".[9] Third, the cost of funds in the securitization must be lower than that offered by the more traditional secured borrowing, such as described above. The securitization transaction is designed to segregate the income-producing assets (in this case, the mortgage, the receivable associated with it and the payment thereof by the mortgagor), from other assets of the business (for example, furniture, art, office space, etc.). Therefore, as a result of this segregation, the investor is not really investing in the company at all. The investment is in the quality of the mortgage receivables transferred to the limited partnership.

It may be helpful to think of it as follows: In business, it is very difficult to control unforeseen events. To take but two possible examples, supposing, for example, environmental contamination was found on land owned by the company or, for example, that directors fail to make source deductions and remittances for their employees. In a traditional secured borrowing, if such events were to occur, it will be a concern that can affect the quality of the security of the lender (in this case, the bank). The bank may seek to realise on its security. In a securitization transaction, neither of these events would affect the investors in any way. As long as the payments from the mortgagors are received on time, the investors are paid as agreed. Further, because the risks of an independent liability removing money from the fund to pay the investors is lower in a securitization transaction than in a traditional secured borrowing, the overall risk is reduced. This reduction of risk results in a lower interest rate in the former than in the latter. To put a number on this, the interest rate may be reduced from 5% to 4.5%. As one reduces the cost of funds, one concurrently increases the profitability of the transaction.

On the flip side of the same coin, if the mortgagors do not pay on time, this is no longer the immediate concern of the originator.[10] After all, the originator no longer owns the receivable. The financial risk however, does not disappear. It is simply

[9]In this context, "bankruptcy-remote" refers to a state where, because the partnership agreement is set up in such a way that the only people to whom the partnership can owe money are the partners (meaning that the partnership cannot go bankrupt), all liabilities of the partnership to the individual partners are contingent on the partnership having sufficient funds out of which the liabilities in question can be paid. The partnership does not conduct business outside of holding the transferred mortgage receivables, and therefore, it is very unlikely that anyone other than partners would have a claim against the assets of the partnership. For further discussion see M. Gillen, and F. Woodman, eds., *The Law of Trusts: A Contextual Approach* 2nd ed. (Emond Montgomery Publications Limited, 2007) 753–758 [Gillen and Woodman].

[10]To a certain extent, the value of the limited partnership interest *does* depend on the repayment of the mortgagor in due course. If none of the mortgagors were to pay the mortgage back and the houses were not of sufficient value to ensure full repayment with interest, the limited partnership interest held by the originator may not be worth as much as expected or even anything at all. However, the success or failure of the mortgages becomes the financial responsibility of the limited partnership, not the originator.

transferred from the originator to the investors. If the mortgagors do not pay on time, there is less money in the limited partnership. If there are insufficient funds in the limited partnership, when the limited partner (in this case, the trust) calls on the partnership to provide it with the funds to pay the investors, the partnership will be unable to provide those funds. In such a case, the investors have a right of action against the trust, but not against the originator.[11]

Another potential wrinkle is that in many securitization transactions, the special-purpose vehicle (in our case, the limited partnership) has no employees of its own. Yet, it owns a receivable that needs to be administered. Who, therefore, will administer the mortgages? The quick answer is that typically, the limited partnership will enter into a contract with the originator to have the originator provide the administration services with respect to the mortgages in return for a percentage of the assets under administration. This means that some of the value that the originator hopes to receive out of the mortgages is actually paid to the originator as administration fees. This comes out of the pot of money that would otherwise be available to pay the investors.

12.3 How Is This Strategy?

To briefly summarise the points above, by introducing the special-purpose vehicle (the limited partnership) in combination with the trust, it can be observed that the legal outcome for the parties can be altered without altering their respective business realities: the originator still administers the mortgages and deals with the mortgagors; the proceeds of the mortgage payments are still used to repay debt instrument(s); profits remaining after the repayment end up with the company.

[11]In fact, in many securitization transactions, there is an additional level of protection for the originator, the limited partnership and the trust. There is often what is referred to as an "indenture trustee" who holds the right of action of all of the investors collectively, pursuant to a trust indenture. This can work in favour of both sides. In terms of the originator, the limited partnership and the trust, this avoids a multiplicity of suits and can allow for settlement of defaults with a single party, that is, the indenture trustee. In terms of the investors, there is power in the collective endeavour of the indenture trustee, especially in settlement negotiations and other litigation decisions. There may also be economic savings in, for example, allowing a single representative to protect the rights of all investors, rather than forcing each investor to seek their own legal counsel and other professionals. It is also possible for the right of the investors to be limited to the acquisition of the limited partnership interest held by the trust. In other words, the indenture trustee steps into the shoes of the trust. In either event, unless assets come into the partnership, there is simply no money in the trust to pay the investors.

To be clear, however, the indenture trustee is separate from the issuer trustee. The issuer trustee administers the activities of the trust. So, for example, the issuer trustee represents the trust in, for example, discussions amongst partners. The indenture trustee thus represents the investors against the trust if the trust is unable to fulfill its obligations to the investors. The issuer trustee, on the other hand, among other things, represents the trust in its dealings with the investors.

Yet, the legal implications of the two arrangements are vastly different. In a securitization, the mortgages are not owned by the company; instead, they are owned by the limited partnership. The company is therefore not responsible for repayment. The company's assets are not at risk.

Also, in a traditional financing, there is significant debt for the company. On the other hand, in a securitization, there is no debt for the company involved, provided that the immediate proceeds are used to repay the bank loan. The company's debt-to-equity ratio is a key element in the decision of most, if not all, lenders, when determining whether to issue further debt to a corporate borrower. Therefore, even though the mortgage receivables do not show up as an asset of the company, it is nonetheless easier for the company to borrow money, given that the debt of the company is reduced while the equity of the company remains unchanged, thereby improving the debt-to-equity ratio, and improving the prospects of further borrowing for the originator.

The segregation of income-producing assets from other assets of the company means that the legal consequences of economic performance of the assets (or liabilities associated with those assets) are also separated from each other. So, if the mortgages perform well, for example, while other liabilities of the company increase, the investors in the mortgages should be reasonably unconcerned. Likewise, if the mortgagors do not pay on time, it will have no direct impact on the shareholders of the company.

The use of the securitization transaction is "strategic" because the parties to it have arranged their affairs so as to pre-emptively determine and control the legal outcome and scope of their dealings. After all, the investor could have invested in the equity of the company but presumably chose not to do so. Therefore, both parties (the company and the investor) are looking for strategic advantage by structuring their affairs in this way. In other words, rather than the company accepting the typical legal consequences of either (1) a secured borrowing from a bank; or (2) a direct equity investment by a sophisticated investor, the company (presumably with the assistance of professional advice) believes that the securitization transaction is economically better for its interests.[12]

[12]There are additional benefits to a securitization. For example, in the banking sector, there are capital-maintenance requirements that may restrict the number of mortgages that a bank as mortgagee may have outstanding at any given time. A securitization transaction with a special-purpose vehicle that does not have any capital-maintenance requirements to restrict its business may allow the bank to maintain the economic benefit and upside of the mortgages which are subject to securitization, while at the same time, in essence, avoid the legal rules that are clearly intended to apply to the bank (that is, in this case, the capital-maintenance requirements). Therefore, at least, this additional benefit is also subject to the same analysis and demonstrates again that a securitization transaction can be used strategically to deliver different results than the more traditional methods. In fact, this is not really done for economic reasons but specifically to avoid legal rules that would otherwise be applicable.

12.4 Why Is This a Good Case Study?

The answer to this question is at least two-fold. First, the legal vehicle of securitization is broadly used. Second, there is an argument that there is little downside to it. Put another way, the "strategic" approach does not necessarily translate into an unacceptable outcome.

On the first point, securitization is used in many different parts of the North American economy, with massive dollar values associated with them. In the mortgage industry alone, $2.5 billion worth of Canadian receivables are securitized.[13] The American experience leads to a value of over $1.3 trillion.[14] This demonstrates that securitization is widely used.[15] Therefore, it is doubtful that the reality of securitization has escaped the notice of anyone who is charged with the task of paying attention. Put another way, if the regulatory rules were aimed at preventing the use of the trust to achieve this flexible and arguably more economically acceptable result, the rules could have been modified by legislation.[16]

On the second point, who is harmed by the use of the trust in these circumstances? The parties themselves have agreed to structure their respective interactions with each other in this way. Therefore, it is difficult to argue that the use of the trust is somehow disadvantageous to one of them.

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[13]See Gillen and Woodman (n 9) 753. The full discussion of securitization runs from pages 753–758. In the interests of full and true disclosure, I should mention that I was the author of the chapter from which these statistics are drawn in the second edition. Professor Christopher Nicholls (now of the Faculty of Law at the University of Western Ontario) wrote the corresponding chapter in the first edition of the same work.

[14]Ibid 753.

[15]Recent events in the asset-based commercial paper market (which uses securitization on several levels) have involved about $32 billion CAD in a proceeding under the Canadian *Companies' Creditors Arrangement Act,* R.S.C. 1985, c.C-36. See *ATB Financial v. Metcalfe & Mansfield Alternative Investments II Corp.* [2008] O.J. 3164 (C.A.) (Q.L.) *per* Justice Blair, for the Court. However, while this crisis may slow certain uses of securitization in the short term, it also serves to underline the widespread use of this strategic tool.

[16]A good example of regulatory response taken to prevent certain economic results can be found in another commercial use of the law of trusts, namely, the business income trust. In 2006, the Canadian federal government of the day calculated the level of tax revenue that it believed it was losing as a result of the increasing use of the business income trust as a financing tool in public offerings. In other words, the government examined the fact that units of business income trusts were being issued, as opposed to public issuances of corporate shares of the business entity underlying the particular business income trust, and found the tax consequences of the former to be more favourable than the latter. So the government changed the tax rules to largely remove the tax-based incentive for the use of the business income trust as part of the public issuance of securities. See Gillen and Woodman, (n 9) 758–762.

We then turn to the issue of creditors. There are two types of creditors: voluntary and involuntary creditors.[17] For those termed "classic voluntary" creditors (persons entering into contracts with the corporation), arguably, they should be able to protect themselves by contractual provisions outlining their relationship with the corporation, such as the taking of a security interest in assets or through other protective mechanisms like covenants in the contract as to the maintenance of financial ratios acceptable to the creditor. If, for business or other reasons, these protective mechanisms are unavailable, it may be that the choice of structure (a traditional financing or a securitization transaction) may have no impact on the protection of the creditor.

With respect to the involuntary creditor, the "classic involuntary" creditor is the tort victim who suffers serious injury at the hands of an employee of the corporation.[18] Such a person does not choose to deal with the corporation, nor can he or she ordinarily protect their interests in advance. Is such a person disadvantaged by the law's allowance of the use of the trust to facilitate the securitization transaction? The answer is not clear in all cases. On the one hand, there are fewer assets in the hands of the company in a securitization transaction than in a secured borrowing. Therefore, there is a smaller pool of assets from which the tort victim can claim recovery. However, in our example, the secured creditor (who would, by definition, rank ahead of the unsecured creditors, including the involuntary tort victim creditor) has been paid off. The remaining assets of the company (other than the mortgages which have been sold to the limited partnership) may remain unencumbered by a security interest in favour of a large creditor. Hence, it is less likely that (when a large tort judgment is registered against the company) a secured creditor will call the loan and sweep up the majority of the company's assets. Also, although the company has "sold" the mortgage receivable to the limited partnership, it maintains an economic interest in those receivables as a limited partner of the partnership. Therefore, the company loses all the debt associated with the mortgage receivables, but may still receive payments when the mortgages are successfully repaid. In other words, the securitization may actually work in favour of the tort victim, as large creditors (like the bank and sophisticated investors who purchased debt securities from the trust) should not be able to have recourse to the assets of the company. Thus, the tort victim may find that there are more assets available to satisfy its claim.

That being said however, it is also possible that the company, having removed some of its debt through the securitization transaction, may choose to incur further debt. The securitization transaction may actually make this a feasible route for the company to take. If it does so, the tort victim may find once again that secured creditors sweep up the assets secured when there is a large judgment against the

[17]For a broader discussion of the distinction between voluntary and involuntary creditors, see the judgment of Justice LaForest, in partial dissent, in *London Drugs Ltd. v. Kuehne & Nagel International Ltd.,* [1992] 3 S.C.R. 299, 348–350. Indeed, Justice LaForest points out that it is possible to have creditors who have attributes of both voluntary and involuntary creditors.

[18]Ibid 349.

company. But this is essentially the same position that the involuntary creditor would have faced in the case of the secured borrowing. Therefore, there is at the very least a strong argument that the involuntary creditor is no worse off following a securitization transaction than he or she would be if a traditional financing were used instead. In fact, there is a possibility that the securitization transaction will benefit the involuntary creditor.[19] Hence, if people will rarely be harmed by the legal strategic approach to the use of trusts in a securitization, is there a reason to prevent the use of the strategic approach? I think not. Securitization certainly has its critics,[20] but considering its widespread use, the criticisms advanced do not seem to deter either investors or companies who wish to use the securitization transaction as financing tool.

12.5 Conclusion

In the end, some may believe that strategic legal thinking is unacceptable. In my view, however, there are cases where this type of strategic thinking may in fact produce more effective results for many of the players concerned, including the creditors who may not be directly involved in the implementation of the strategic alternative. The use of the trust to facilitate the securitization transaction appears to be a case where, in general, this seems to ring true. So while the trust is often used in commercial law strategically, it does not necessarily always follow that its use is either negative or nefarious.

[19]In a general discussion, such as this contribution, it is difficult to anticipate all scenarios that might occur at some point in the future with respect to the interaction between creditors, on the one hand, and the company, the trust and the limited partnership on the other. Therefore, it would be unrealistic to think that a scenario reasonably considered to be unjust to the "classic involuntary" creditor could never arise from the use of the trust in a securitization. In other words, I acknowledge this as a possibility. However, in circumstances where such an outcome occurs, it is also important to note that the legislature is always empowered to act to change the rules (or create new rules) to prevent the recurrence of this outcome.

[20]See for example, L. M. LoPucki, "The Death of Liability" (1996), 106 Yale L.J. 1.

Chapter 13
Activist Hedge Funds and Legal Strategy Devices

Eveline Hellebuyck

Abstract Hedge funds are increasingly being acknowledged as significant players in the financial markets area. Although hedge funds are considered as enjoying a "light" regulatory regime, they are still obliged to comply with the prescripts that govern corporate decision-making and resulting financial market processes. In order to make these rules less restrictive in nature, hedge funds are utilising legal strategies which are proving to be a very lucrative source of rule manipulation.

13.1 Introduction

"Legal strategies" are typically perceived as being a part of the administration of some kind of corporate undertaking. From this point of view, legal strategies can also be considered part of a corporation's managerial framework aimed at maximising corporate returns. Hence, the implementation of legal strategies can be regarded as a device that helps shape corporate behaviour in such a way as to contribute to the production of enhanced profit results in a likewise improved cost-efficient way. Since the legal strategies element is truly a component part of the context which the company resorts to in modelling its economic behaviour, legal strategies, as a rule, are associated with the manner in which the company acts as an economic agent.

Legal strategies, however, can also include the view that a company itself is an object ready to be manipulated so as to shape it into an asset capable of generating the level of profitability sought. This perception of the company as some kind of "mouldable" property is obviously no longer the domain of corporate management, but is rather attributable to the competence level of the shareholding public. Treating companies as manageable assets in a portfolio and becoming actively

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involved in such management is considered to be part of the province of the activist hedge fund.[1] Instead of focusing on the company as an actor in an economic environment, the activist shareholder is concerned with influencing or directing the company's economic behaviour in such a way as to increase the economic performance of the shareholder himself or herself. In order to obtain a better economic return for their own underlying fund, the activist can be seen to deploy legal strategies as well, not as the initiator of legal strategies implemented by the company, but rather as a third-party entity aiming profit-enhancing tools at the target company. This contribution discusses some of the legal strategies implemented by activist hedge funds in order to provide their own investors with the promised double-digit returns.

13.2 Types of Legal Strategies Concerned

The legal strategies of concern here can be viewed as similar to those which have been dealt with, at least in part, by the so-called concept of "fraude à la loi" (in Dutch known as "wetsontwijking"). The term "fraude à la loi" is used to describe a certain type of rule manipulation that stems from continental law making it somewhat difficult to translate into the language of the common law.

With that potential limitation in mind then, the notion of "fraude à la loi" denotes the following: A technique by which a person, through the execution of certain operations, enables himself or herself to alter a situation which would normally be governed by certain regulatory constraints so that those same regulatory constraints no longer apply. While the operations themselves are reconcilable with the judicial framework (within which the regulatory constraints also reside) and are therefore unlikely to be successfully challenged in court, the result achieved was unintended from the legislator's point of view and is therefore viewed as undesirable.[2]

[1]For a good description of what "activism" means in this context, see I. Anabtawi, and L. A. Stout, "Fiduciary Duties for Activist Shareholders" (2008) UCLA School of Law, Law-Econ Research Paper No. 08-02 4–5, online: SSRN http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1089606 [Anabtawi and Stout]; See also T. W. Briggs, "Corporate Governance and the New Hedge Fund Activism: An Empirical Analysis" (2007), 32 J. Corp. L. 695 [Briggs] which gives a more restricted sketch of the term "hedge fund activism"; See also A. Kay, T. Platts, and H. Kumar, "How It Works" (2007), 26 International Fin. L. Rev. 54–56 [Kay, Platts and Kumar]; Displaying activist tendencies is also sometimes cited as an alternative to the so-called Wall Street Rule according to which an unhappy investor simply decides to put his shares back on the market. See for example, S. M. Bainbridge, "Investor Activism: Reshaping the Playing Field?" (2008) UCLA School of Law, Law-Econ Research Paper No. 08-12 and Kay, Platts and Kumar ibid 54.

[2]See P. Van Ommeslaghe, "Abus de droit, fraude aux droits des tiers et fraude à la loi" (1976) 4 Revue Critique de Jurisprudence Belge 303–350. Under Belgian law, the validity of the "fraude à la loi" theory in a tax law environment is generally not accepted since it is thought to be inconsistent with the tax law governing principle of legality that offers the taxpayer the possibility to put himself in the situation that is least capable of generating tax liability. See S. Van Crombrugge, *De grondregels van het Belgisch fiscaal rech*t (Kalmthout: Biblo, 2005) 25–32.

Before addressing the potential possibilities for generating a higher net economic result through the use of legal strategies, it might first be helpful to consider what sets hedge funds apart from the more traditional types of pooled investment.

13.3 What Makes Hedge Funds Different from Traditional Pooled Investments?

13.3.1 Hedge Fund Definition

Generally speaking, a hedge fund is a pooled investment vehicle. However, unlike traditional investment vehicles which typically use non-leveraged, long-only strategies (for example, mutual funds), hedge funds are more aggressive, seeking positive absolute returns regardless of the performance of an index or sector benchmark.[3]

It is commonly accepted that although hedge funds became a noted phenomenon at the end of the 1990s, likely attributable to the broadly covered collapse of the notorious Long Term Capital Management fund,[4] the precise definition of the term "hedge fund" still remains largely undiscovered.[5] Despite this apparent lack of definition, the United States (US) Securities and Exchange Commission (the SEC) provided a working definition of a hedge fund when it issued its final rule with respect to the registration of hedge fund advisers. While this rule was to be later vacated in *Goldstein v. SEC*,[6] the US federal securities regulator nonetheless provided clarification and a useful definition of hedge fund. This definition is comprised of three main elements as follows:[7]

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[3]See G. S. Amin, and H. M. Kat, "Hedge-Fund Performance 1990–2000" (2003) 38(2) Journal of Financial and Quantitative Analysis 251–252.

[4]For a closer look inside this notorious case, see: "Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management" (28 April 1999), Report of The President's Working Group on Financial Markets, online: USTREAS http://ustreas.gov/press/releases/reports/hedgfund.pdf.

[5]See for example by W. W. Bratton, "Hedge Funds and Governance Targets" (2007) ECGI-Law Working Paper No. 80/2007 8, online: SSRN http://papers.ssrn.com/sol3/papers.cfm?abstract_id=928689 [Bratton]; See also Briggs (n 1) 686.

[6]*Phillip Goldstein, et al. v. Securities and Exchange Commission* (2006) 451 F.3d 873 (D.C. Cir.); For a brief but further consideration of this vacation, see: Lowenstein Sandler PC, "Court Vacates SEC Rule Requiring Hedge Funds to Register" Investment Management Group Alert, (June 2006), online: lowenstein.com http://www.lowenstein.com/files/Publication/1955a703-3138-4e7b-8b1b-017df55c616c/Presentation/PublicationAttachment/1e35596c-aac4-4964-8e40-0204bf32344f/Investment%20Management%2006-06.pdf.

[7]See US Securities and Exchange Commission (SEC), "Final Rule: Registration Under the Advisers Act of Certain Hedge Fund Advisers" (2004) Release No. IA-2333, II.E. Definition of "Private Fund", online: Final Rule http://www.sec.gov/rules/final/ia-2333.htm#IIE.

First, the SEC stresses the fact that, but for the exemptions contained in section 3(c)1 and section 3(c)7 under the US *Investment Company Act*,[8] hedge funds would otherwise be subject to the same registration requirements as traditional investment funds and thus would be obliged to register as an investment company under that Act. In order to qualify for these exemptions, hedge funds must not be marketed to the general public and are therefore by definition, private.

The second key element of the SEC definition concerns the widespread hedge fund practice of offering the investor a right to redeem after an initial lock-up period of less than two years.[9]

Third, the SEC observed that in order to be a hedge fund, its investors must rely mainly on the stock-picking ability of the hedge fund adviser in choosing the hedge fund pool most eligible for investment.

Obviously, many different private investment vehicles (applying divergent investment strategies) potentially come under the SEC definition of what might constitute a hedge fund. In this contribution however, focus is only given to that particular subset of the hedge fund asset class which can be denoted as adopting an "activist" investment strategy.

13.3.2 Capacity for Activism

In the same way that it should be stressed that not all hedge funds use activist investment strategies to produce returns, it should also be observed that traditional institutional investors might also take recourse to "activist" shareholder behaviour. Having said that however, the activist tendencies that can be observed in traditional investment pools might be better explained as being largely "coincidental". This observation arises out of the fact that traditional investment vehicles are greatly constrained on account of their regulated status. For example, funds registered as an investment company under the US *Investment Company Act* are obliged to adopt an investment policy that can be described as "diversified".[10] Because of this legally mandated diversification, investment companies are not allowed to concentrate

[8]U.S.C. 80a-1 et seq [*Investment Company Act*].

[9]Bratton discerns possible lock-up periods that exceed the two year limit. See Bratton (n 5) 10; The Children's Investment Fund (TCI), a London hedge fund, has half of its investors facing a lock-up of no less than five years while the other half is in for three years. See J. Mackintosh "TCI loses $1bn in worst month" Financial Times, (14 July 2008), online: FT.com http://www.ft.com/cms/s/0/ca0df5b6-51cd-11dd-a97c-000077b07658.html; The main reason why the SEC puts forward a maximum lock-up of two years is to preserve the ever-blurring line between hedge funds and private equity. The latter is considered to have a much more long-term investment horizon.

[10]Under the *Investment Company Act* (n 8), it is possible for the registered investment fund to be labelled as non-diversified, but this is an atypical status and does not exclude the fund entirely from adopting a policy of diversification. In fact, only half of the assets under management are exempted from the diversification requirement, as long as the fund wants to remain eligible for some valuable tax benefits under subchapter M of the Internal Revenue Code. See T. L. Hazen, *Securities Regulation: Cases and Materials*, 7th ed. (Thomas West, 2006) 1169–1170.

their investments in a single target company, thereby making it harder to accumulate the level of ownership required by an activist strategy.[11]

Similarly, with respect to corporate pension plans, the US *Employee Retirement Income Security Act of 1974*[12] (*ERISA*) not only obliges plan fiduciaries to adopt some form of diversification policy, it also compels them to take a certain level of care with respect to the voting rights attached to the equity investment. Specifically, under *ERISA*, voting rights are equated to plan assets and are therefore subject to the prudency and exclusive benefit requirements that are imposed on the plan's fiduciary. These requirements make it more difficult for such funds to use activist behaviour.[13] After all, it is the fiduciary who bears the responsibility for an action that is considered as having failed to produce a favourable cost–benefit return. These latter obligations (and attendant consequences) can be seen as having a restrictive effect on the adoption of an activist investment strategy similar to the obligation to diversify asset allocation, notwithstanding the fact that this has as such been identified to a much lesser extent in non-US literature.

By contrast, hedge funds are largely unregulated which goes a long way to liberate them from the constraints that impact on other types of pooled asset funds. Hence, hedge funds can implement activist behaviour on a more regular basis, allowing its activism to bring about changes in companies so that the companies display exactly that kind of economic behaviour that the hedge fund's managers believe will generate wealth for the fund's investors.

13.4 Legal Strategies

13.4.1 By Exploiting Shareholder Status: A Case of Empty Voting

Using activism as a strategy for managing a portfolio's shares presupposes the ability to actually influence how the company implements its task as an economic entity. This influence over the company's economic behaviour can be fulfilled through the exercise of shareholder voting rights. Exercising voting rights is of

[11]See Anabtawi and Stout (n 1) 30; It should be noted however, that at the time TCI started its activist campaign within ABN Amro, a Dutch Bank, it could only account for 1% of the company's shares. See N. Cohen, and P. T. Larsen, "TCI urges ABN shake-up", Financial Times, (21 Feb 2007). Nonetheless, this 1% participation made TCI the second or third largest shareholder within ABN Amro, something that would be hard to achieve for a mutual fund restricted by the rule it should only allocate a maximum of 5% of its assets value to the holding of securities relating to one single issuer.

[12]Pub.L. 93-406, 88 Stat. 829, enacted 2 September 1974.

[13]See discussion in B. S. Black, "Shareholder Passivity Re-Examined" (1990) 89 Mich. L. Rev. 553–556; See also memorandum from the Groom Law Group to the Council of Institutional Investors concerning Department of Labor Advisory Opinion 2007-07A explaining the voting of proxies under ERISA, online: Council of Institutional Investors http://www.cii.org.

course perfectly compliant with the legal concept of shareholdings. However, as it will be demonstrated, this seemingly benign shareholder concept is particularly vulnerable to the legal strategies executed by hedge funds aimed at better returns. In keeping with the idea underlying the continental theory of the "fraude à la loi" as discussed above, these legal strategies are not used as instruments to infringe regulatory schemes. Rather, these strategies serve as tools that can bend regulatory schemes in the direction that benefits the hedge fund in the best possible way.

One *modus operandi* frequently associated with hedge funds – and deserving of attention in the context of legal strategies – is the decoupling of voting rights from economic interest. The convergence between those two basic notions however, is essential to legitimise the idea of being able to exert influence over corporate behaviour and in fact makes up the rationale behind the standard legislative choice to safeguard a shareholder's right to vote. After all, since the shareholder is the closest thing to a true "owner" of the company, the shareholder has a legitimate interest in ensuring that he or she has a voice with respect to company performance.

Because hedge funds use activism as a strategy to produce investment returns, they turn to the voting rights concept whenever certain company conduct is required to realise the strived for returns. In a perfectly balanced system, the exercise of one's voting rights in one direction or another is properly motivated by one's interest in the company's assets. Since the performance of the company is directly connected to the value of the company's shares, this voting behaviour should, at least in theory, benefit the general interests of all the shareholders.

Hedge funds, however, use modern derivatives techniques[14] in order to have their voting rights decoupled from the underlying economic interest. This means that the hedge fund can vote without being hindered by a future harmful effect the vote cast might have on their own shareholdings. Thus, the hedge fund can fully exploit the ability to use those voting rights to the sole benefit of their own return targets, rather than to the general interests of all shareholders of the company with respect to which the vote was cast. The derivative product most suited to do the job is the one residing under the so-called "swap technique".

As much as there are different types of derivatives, there are also different variations on the basic techniques concerning how to use a single type of derivative. Consequently, multiple derivatives products can be labelled as "swaps". Activist

[14]Derivatives generally speaking are "contracts that gamble on the future prices of assets – are secondary assets, such as options and futures, which derive their value from primary assets, such as currency, commodities, stocks, and bonds. The current price of an asset is determined by the market demand for and supply of the asset; however, the future price of an asset typically remains unknown. A week or a month in the future, the price may increase, decrease, or remain the same. Buyers and sellers often like to hedge their bets against this uncertainty about future price by making a contract for future trading at a specified price. The contract – a financial instrument – is called a derivative". See Government of Canada, *Economic Concepts: Derivatives*, online: Derivatives http://canadianeconomy.gc.ca/english/economy/derivative.html.

hedge funds often use one variation of a swap in order to achieve a decoupling result. It resembles a credit default swap type which normally serves as protection against future losses for a certain portfolio asset.

The swap transaction involves two key parties. The first party is the protection buyer, who is seeking to protect the asset against future losses. The protection seller, the second party, provides for the protection sought. Generally speaking, the protection seller agrees to buy the asset from the protection buyer at a certain point in time for a pre-arranged price. Consequently, if the asset declines in value over time, the protection buyer does not suffer any loss since he or she will regain from the protection seller, the price originally paid.

When the swap technique, as described above, happens to concern a physical delivery settlement, the asset subject to protection is physically transferred from the protection buyer into the hands of the protection seller. The same net result can be achieved by replacing the physical delivery of the assets with a cash settlement. In this latter case, there is no actual transfer of the asset for which protection is sought since the protection seller's obligation is simply to reimburse the protection buyer for the difference between the original price of the asset and the current market value. Obviously, the obligation to reimburse is only triggered when the asset has actually suffered a decline.

On the other hand, it is quite possible that the asset will increase in value rather than decline. When this occurs, the obligation to pay up may well rest on the protection buyer dependent on the contractual obligations. This situation can arise in a "contract for difference" (CFD) which is not all that different from a physical delivery of assets as it might first indicate. For example, in the case of a physical delivery, the protection seller will likewise benefit from a rise in the asset price, since he or she will receive from the protection buyer, the actual asset in return. The main difference between the two however, is that a true CFD agreement involves the ability to speculate on price movements without actually having to buy or sell the speculated asset as it will only settle based on the difference in the price quotation. It is this kind of settlement variation that usually delivers the foundation for the equity swaps preferred by activist hedge funds as a device to obtain a decoupling of voting rights and economic interests.

The foregoing review of the basic physical delivery settlement type of transaction (with the attendant transfer of physical property) is helpful because it makes it easier to observe the actual positions of the parties underneath the swap transaction. The protection buyer's position can be referred to as a "short" position, since the protection buyer is holding an asset in portfolio which he or she is obliged to give up at a certain point in time. The protection seller, in turn, holds a "long" position, given that through his or her obligation to eventually take over the asset he or she already holds it in portfolio even though the actual asset transfer is to take place at a future point in time. Hence, it is not so difficult to see why short positions are considered to anticipate a price drop, while in contrast, long side positions speculate for prices to rise.

With the foregoing in mind, the following question can now be raised: To what extent is an equity swap actually able to serve the purpose of rule manipulation so

that a benefit is gained? Perhaps the answer to this question can best be illustrated by reference to a case example:

Activist hedge funds often find themselves, intentionally or otherwise, on both sides of a merger transaction. Assume that an activist hedge fund has its interest in one of the companies secured by a swap as described above. We will call this Company #1. The use of the swap means that every decline in the future value of Company #1 is covered by the swap. Therefore, there is no economic reason hindering the hedge fund from using its participation in Company #1 to induce Company #1 to go through with the merger, even if the merger would entail a decrease in stock price of Company #1.

The reason that the hedge fund would want to push Company #1 into such a transaction is that the hedge fund is also participating in a second company, Company #2, with the fund's shareholding position in Company #2 benefiting from the merger transaction. Clearly, in this scenario, although the use of the voting rights that the fund has in Company #1 diverges from the economic interest it has with respect to Company #1, the divergence ultimately serves the purposes of the fund. Although the fund, strictly speaking, is not evading a specific rule telling it not to vote in this manner, the fund is obviously ignoring the rationale or policy behind the law's choice to protect the right to vote, i.e. the assumption that the shareholder has the same interest as an owner in deciding the company's behaviour. The situation created by the fund – access to voting rights without exposure to the economic interest underlying those rights – is commonly called "empty voting"[15] and constitutes the kind of manipulation that fits four-square into the concept of legal strategy.

Voting rights are also sometimes decoupled from the underlying economic interest in the case of so-called control enhancing mechanisms (CEMs). CEMs cause voting rights to occur in quantities that are disproportionate to company asset entitlement.[16] Company asset entitlement is often calculated on the basis of the amount of dividend rights and entitlement to the company's liquidation surplus. If voting rights are significantly higher in relation to the percentage of these other rights, the voting of the shareholder with the increased voting right could be considered empty voting as well, or at least imply a decoupling result similar to that described above.[17] From the perspective of legitimacy however, there is quite a

[15]For further discussion on the concept of "empty voting" see: H. T. C. Hu, and B. Black, "Empty Voting and Hidden (Morphable) Ownership: Taxonomy, Implications, and Reforms" (2006), 61 The Business Lawyer 1024–1026 [Hu and Black]. Hu and Black extensively discuss possible decoupling situations; See also M. Kahan, and E. Rock, "Hedge Funds in Corporate Governance and Corporate Control" (2006) ECGI-Law Working Paper No. 76/2006 41–42, online: SSRN http://papers.ssrn.com/sol3/papers.cfm?abstract_id=919881.

[16]The term cash flow rights is also sometimes used here.

[17]See for example: P. Santella, E. Baffi, C. Drago, and D. Lattuca, "A Comparative Analysis of the Legal Obstacles to Institutional Investor Activism in Europe and in the US" (2008) SSRN Working Paper 34–41 [Santella, Baffi, Drago and Lattuca], online: SSRN http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1137491.

difference between this latter type of empty voting and the empty voting considered in relation to hedge fund activism, described earlier.

For instance, frequently quoted examples of CEMs are as follows.

First, there is the "golden share technique" where one shareholder may have shares that carry greater voting power than shares of other classes, held by most other shareholders. This technique is sometimes used to facilitate a privatisation process. The second example is the so-called "pyramid" structure. This is where an individual or group has 100% ownership of the parent corporation but where the parent has a lesser percentage of a subsidiary. The parent has, for example, a 60% interest in the subsidiary, but can control 100% of its behaviour.[18] Also, the subsidiary may control only 51% of the votes of its own subsidiary. Yet, the parent maintains indirect control of its sub-subsidiary.

Both the golden share technique and the pyramid structure allow for an entity to have a bigger controlling stake than the amount of the entity's underlying shares. As concerns the pyramid structure, this bigger controlling stake is actually indirectly obtained through control of the level below that directly holds the participation in the target. In our example, as mentioned above, the parent maintains effective control over both subsidiaries.

The golden share technique is a more straightforward deviation from the "one share, one vote" principle, since it allows the shareholder – being an entity regulated by public law – to cast more votes than his equity participation in case contentious matters are up for vote. In this case, there is undoubtedly a certain resemblance to the "empty" voting situation in relation to activist hedge funds. Indeed, when CEMs are used, the user also has more voting rights than he or she has money at stake in the company. However, unlike the "empty" voting situation with respect to hedge funds, an economic stake continues to be present. Further, the shareholder who typically has inferior participation as far as voting rights are concerned, has had this inferiority calculated into the price of the shares.[19] From a shareholder's point of view, these two points, among others, indicate that the situation created by the use of CEMs is far more justifiable.[20] Given that CEMs are usually adopted for the purpose of anchoring the *de facto* control of a company, for

[18]See for example: Commission of the European Communities, "Impact Assessment on the Proportionality between Capital and Control in Listed Companies" (December 2007) Commission Staff Working Document SEC(2007) 1705 [Commission Staff Working Document] online: European Commission http://register.consilium.europa.eu/pdf/en/07/st16/st16603.en07.pdf.

[19]Hu and Black (n 15) 1027.

[20]Indeed, CEMs are considered to possibly stimulate the one in control to subtract "private benefits" from the company to the detriment of the minority shareholders, but this extraction of private benefits mostly concerns traditional conflict of interest issues such as having the insider buy a certain company asset below the market price. See Commission Staff Working Document ibid 14–16.

example in a family business, they are likely more of an obstacle to hedge fund activism than a tool that they might be able be employ.[21]

The entanglement between CEMs and true empty voting situations is complicated by emerging evidence that corporate insiders are also using derivatives to secure their equity participations. This type of stock position security has quite a different motivation than the one underlying the empty voting techniques of activist hedge funds as described above. The main purpose of derivatives usage by corporate insiders lies in the hedging possibilities offered by derivatives. The only thing the corporate insider wants to achieve is maintenance of his or her hold on the participation that allows for control of the company without having to compromise his or her risk evaluation checks.[22]

In other words, some corporate insiders, for a variety of reasons, feel the need to invest heavily in the corporation of which they are an insider. In such a case, the corporate insider may use derivatives as a hedging mechanism against losses, that is, as an alternative to portfolio diversification, because they are so heavily invested in a single company. Generally speaking, in such a scenario, the insider has no intention of jeopardising the value of the company's assets. The hedging process used here is typically also associated with the usage of put and call options and is mainly concerned with minimising the risk attached to the holding of a significant asset class in portfolio, implying exposure to a long position. In order to serve as a hedge for a given long position, a synthetic options technique is utilised and is comprised of simultaneously buying a put and selling a call option for the same premium and at the same strike price. This synthetic options construction, taken on its own, is only lucrative when stock prices are suffering a decline. When stock prices decline, being on the buying side of call is not a good option since the strike price of the call will presumably exceed current market value. It is also not profitable to be on the selling side of a put when prices are falling since the buying side will most definitely be eager to force the shares on its counterparty, obliging the latter to buy at an unfavourable price. Under falling market conditions, the profit gained from selling the call added to the surplus coming from buying the put roughly mimics the situation in which physical stock is being put into a short position, since going short on stock equally assumes speculating for a future price decline. Given that the call is sold for the same premium for which the put is bought, the synthetic options technique realises a net neutral outlay. To summarise then, a combination of options can provide a unique opportunity to offset possible losses on long equity positions in case market prices drop.

The empty voting situation is perhaps more similar to the obtaining of votes through a securities lending transaction. This transaction is, apart from some important deviations, as its name suggests. A borrower borrows securities from a lender in return for cash compensation accompanied by an obligation to eventually

[21]This was considered by Santella, Baffi, Drago and Lattuca in relation to the activism displayed by minority investors in general. See Santella, Baffi, Drago and Lattuca (n 17) 41.

[22]Hu and Black (n 15) 1025–1027.

return those securities to the lender.[23] Hedge funds, activist or not, often turn to the securities lending business in order to take advantage of the economic benefits of short selling. Although short selling does not entirely coincide with simply holding a short position, short selling is also referred to as occupying a short position. The reason for this is that the term "short" refers to a situation in which the initiator of the position speculates that there will be a fall in prices. Short sellers sell the securities obtained from the lender to an individual third party. When the securities are sold they are worth, say, $100,000. At a certain point in time, the short seller is obliged to return an equal amount of securities to the lender, which obligation the short seller hopes to fulfil under falling market conditions, when the securities are worth, say $85,000, thereby creating a profit of $15,000.

Short selling is not the only reason for a hedge fund to enter into a securities lending contract. Another reason for entering securities lending would be to obtain the voting rights attached to the equity borrowed. Borrowers initiating a securities lending transaction for the sole purpose of acquiring votes in anticipation of an upcoming general meeting are often accused of being able to vote in a way that benefits their own interests while leaving the economic risk of the shares with the lender.[24] At first blush, this may seem similar to the empty voting problem triggered by derivatives use, but there are some important differences. These in turn can cause distinctions in the perceived level of legitimacy between the two techniques.

A securities lending transaction does allow the borrower to "capture" the record date of a company. The record is the date at which the voting rights for a particular meeting of the company are determined. "Capturing" the record date means that the borrower is returning the securities immediately after the record date is established. This in turn means that the borrower is able to attend the general meeting, even though at the time the meeting is held and thereafter, the borrower does not hold the securities. Therefore, the borrower is actually not exposed to the underlying economic risk of the votes cast. The borrower can then vote for the sole benefit of his own interests even if it means voting counter to the interests of the lender.

It cannot be denied, though, that this activity is done with the explicit or implicit consent of the lender who has both agreed to the lending contract while simultaneously failing to intercept the risk arising out of the same contract or the provisions of a separate contract.[25] Of course, there are other shareholders (aside from the

[23]For a better understanding of what securities lending exactly encompasses, see: M. C. Faulkner, *An Introduction to Securities Lending*, 3d ed. (International Securities Lending Association (UK) and others, March 2004) [Faulkner], online: rmahq.org http://www.rmahq.org/NR/rdonlyres/49EC2955-3A7F-48A1-824D-35A3D5CE0168/0/AnIntroductiontoSecuritiesLendingThirdEdition.pdf.

[24]See Hedge Fund Working Group (HFWG), "Hedge Fund Standards: Final Report" (January 2008) 98, online: hfsb http://www.hfsb.org; See also Santella, Baffi, Drago and Lattuca (n 17) 34–41; See also Hu and Black (n 15) 1027–1029.

[25]When addressing the voting issue in relation to securities lending, Santella, Baffi, Drago and Lattuca, for example, indirectly indicate that the master agreements governing transactions of securities lending possibly contain clauses imposing instructions by which the voting rights

consenting lender) who equally suffer the potential decline in share prices, but the same effect occurs if the borrowing entity buys the shares just before the record date in order to get his voting rights established and then sells them again immediately after this assignment but prior to the general meeting.[26] After all, when there is a securities-lending transaction, the ownership of the securities borrowed is also conveyed, resulting in the voting rights attached to them being transferred as well. The obligation of the borrower, aside from providing his or her counterparty prior to the transaction with sufficient collateral, is to return an equal amount of securities to the lender.

Apart from the element of consent, there is another distinguishing factor that sets securities lending apart from the use of derivatives. The lender is being compensated for the actual act of lending, be it: (1) pecuniary compensation for the lending transaction as such; or (2) the receipt of other benefits such as the avoidance of taxes from being imposed. Consequently, one might assume that the lender agrees to having his or her shares voted in a certain direction as long as he or she receives compensation for the votes abandoned in favour of that direction. This situation does not differ so significantly then from the practice of vote buying, whereby a party literally sells his or her vote to a buyer who in turn can exercise the voting right in any direction. In any event, voting borrowed securities, although completely legal, is considered to be an illegitimate use of a technique that, albeit legitimate in origin, was not conceived to cover such usage[27] and therefore can be considered a legal strategy for the purposes of this volume.

13.4.2 By Rule Manipulation

Under the swap arrangements previously considered, the activist hedge fund held the short position as opposed to the person holding a long position resulting from his status as protection seller. By using the swap technique the other way around, activist hedge funds can benefit from the use of legal strategies a second time.

In this second situation, the activist hedge fund plans to manipulate a genuine legal rule, as opposed to connecting to a certain status such as the status of a shareholder.

The rule at issue is contained in section 13(d) of the US *Securities and Exchange Act*, *1934*.[28] The rule, along with Schedule 13D, requires notification to the SEC of any holding – including beneficial ownership – of more than 5% of the securities concerned.

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attached to the securities borrowed should be exercised. See Santella, Baffi, Drago and Lattuca ibid 35.

[26]See Hu and Black (n 15) 1029.

[27]See for an example, Faulkner (n 24) 5.

[28]15 U.S.C. §78a et seq.

Having beneficial ownership of the shares either: (1) implies the power to vote those shares ("voting power"); or (2) coincides with the power to decide on their acquisition and disposal ("investment power"). The purpose of the notification requirement is to inform the investing public of the presence of a 5% shareholder, who could use its voting power to influence the level of control within the company.[29] After all, market efficiency tends to react to notifications involving potential control changes as investors anticipate a possible control shift by way of adapting the price levels at which they are willing to trade.[30] Since activist hedge funds by their very nature are aim at influencing corporate control (these activist tendencies can even culminate in the launching of a proxy contest), all those holdings exceeding the 5% threshold are obliged to meet notification requirements under Schedule 13D. Again, the swap technique offers a way out – this time the activist hedge fund occupies the protection seller side.

Schedule 13D imposes its notification requirements merely on the assumption that the equity possession of the filer corresponds to beneficial ownership. It is inherent to the position of protection seller that it is without possession of the asset concerned. Therefore, the activist hedge fund neither possesses the power to vote nor the ability to decide on investment. However, in a swap involving physical delivery of the security, the long position of the protection seller provides the right to future possession of the asset. It is exactly that kind of future possession that can trigger the notification requirements under Schedule 13D. On the other hand, a swap involving a cash settlement, as opposed to settlement of the physical asset, does not have this consequence because there is no right to the future possession of shares, only to a cash settlement.

This is exactly what the activist hedge fund gets into, when it steps into an equity swap agreement with its investment bank.[31] In this type of swap, an investment banker will hold the short position. Since it is a cash settlement swap agreement, the investment bank holds this short position without actually holding the underlying stock. Neither the protection buyer, being the investment banker, nor the protection seller, the activist hedge fund, can thus be identified as the one maintaining actual possession of the asset. Therefore, no one holds shares that require Schedule 13D notification. Why then does it matter that the activist hedge fund is the protection seller?

The answer to this question is two-fold. First, the activist hedge fund does in some way eventually aspire to obtain the underlying equity participation, so being

[29]The Schedule 13D notification requirement is connected with the disclosure of the filer's intention to behave as an activist investor. Therefore, certain empirical studies use the information generated by the filings to compose samples of companies allegedly affected by activist shareholdings. See for example, R. Greenwood, and M. Schor, "Investor Activism and Takeovers" (2007) SSRN Working Paper, online: SSRN http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1003792.

[30]See J. Mackintosh, "Disclosure Demands Build up Steam", Financial Times (6 June 2008) [*Steam*].

[31]See J. Coffee, "Regulators Need to Shine a Light on Derivatives", Financial Times (30 June 2008); See also *Steam* ibid.

the one holding the long position in this case is the most obvious choice. In other words, holding the long position in the swap represents the desire of the fund to eventually achieve some kind of future possession status.

Second, in this transaction, the investment banker does not really speculate on a price decrease. The investment banker is engaged for the purpose of acquiring the service fees associated with it. Therefore, the short position makes sense for the investment banker. If the investment banker wants to protect the investment, as required by an adequate risk management policy, the banker will take a corresponding long position. This usually means that the investment banker will buy the underlying shares and put them into portfolio. When the swap is later unwound and the short position exposure is consequently terminated, the investment banker will want to get rid of the shares in portfolio since the long position they represent is no longer needed to cover the short position. The only thing remaining for the investment banker to do, is to put the equity assets that once served as a hedge for the short position, back on sale. In doing so, one of the likely potential buyers is the activist hedge fund![32] In short, this equity swap enables the fund to accumulate a significant equity participation at a most favourable price since this accumulation action takes place secretly. Therefore, this is less likely to trigger an increase in share price.

Hence, this swap gives rise to the same outcome as does a physical delivery settlement, except for the fact that the element of delivery is replaced by a selling transaction triggered by the unwinding of the swap and executed by the protection buyer the moment the participation is revealed. As a result of the transaction, the price the activist hedge fund eventually pays for the shares is already dated. Occupying the long side of an equity swap agreement is in fact exactly the opposite to holding voting rights without the corresponding economic interest as this long position gives the entity taking it up economic exposure but no voting rights.

Apart from this profit making result, there still remains the element of surprise with respect to the target company itself when its management wakes up one day to find itself suddenly confronted with a significant and perhaps even more importantly, activist shareholder. This is exactly what happened to Neil Ashe, CEO of CNet, when hedge funds Jana Partners and Sandell Asset Management unexpectedly emerged as a 21% shareholder who was planning to launch a proxy contest.[33] A similar situation caused US railway operator CSX to sue hedge fund The Children's Investment Fund (TCI) for voting shares allegedly not properly disclosed.[34] The court found itself unable to prevent TCI from voting the shares underlying the swap agreement, because the court's *amici*, including the SEC, clearly opposed requiring notification as far as long side counterparties in an equity

[32]Hu and Black (n 15) 1029–1031.

[33]A. S. Sorkin, "Hedge Funds Use Loophole To Get a Foot in the Door", N. Y. Times (15 January 2008).

[34]J. Mackintosh, "TCI ruling to Hamper Stakebuilding", Financial Times (13 June 2008); See also *Steam* (n 31).

swap arrangement are concerned. Nonetheless, the court wrote that TCI had used the equity swap to get around its legal obligations.

As a result of the finding that there was an intention to circumvent the rules, the court considered TCI a beneficial owner under section 13(d)–3(b) of the *Securities and Exchange Act*. This rule allows the court to attribute beneficial ownership of securities to the initiator of a plan or scheme set up for the purpose of preventing the application of 13(d). The court did not resolve the question whether the equity swap position did in fact constitute beneficial ownership but the court nevertheless considered a few key elements germane to this question. As previously pointed out, in order to meet risk management standards, bankers holding short positions also add long positions to their portfolio. Despite the fact that they initially opt for entering into a cash settlement swap with no corresponding asset holding, these bankers, for the sake of their own risk management needs, actually decide to buy the underlying equity position, keeping it in portfolio as a long so as to offset the short position entered into as part of the swap.

Although buying the actual physical shares is not the only way to create a hedge against the risk associated with a short position, in such a case it is the most likely one. According to the court, TCI was well aware of the fact that its banker-counterparties would hedge their short positions by holding the shares in the same company in portfolio as a long position. To support this view, the court drew attention to the fact that TCI actually spread its swap positions among several banker-counterparties, presumably so as to avoid those banks, through the shares they purchased for hedging reasons, from becoming subject to Schedule 13D requirements themselves. In fact, by entering the swap agreements on the long side, TCI in a way forced the banks into purchasing the corresponding physical shares that subsequently, would be sold again as soon as TCI decided to unwind the swaps. Thus, in relation to those physical shares, one could easily consider TCI as being the person having the investment power.[35]

Only a few weeks after the TCI ruling, the United Kingdom's Financial Services Authority (FSA) announced its intention to set up a regulatory scheme to force disclosure requirements on equity swap participants when participations rise above the 3% threshold.[36] The FSA's plan is to have this in place by the end of 2009. Although the FSA previously expressed its willingness to consider a disclosure scheme "light" as contracts for difference are concerned, it now seems to fully support the view that the potential access activist hedge funds have to derivatives use poses a threat to the market system that should be taken seriously.

[35]*CSX Corporation v. The Children's Investment Fund Management* (2008) 08 Civ 2764, (SD NY).

[36]J. Hughes, and J. Mackintosh, "TCI fronts challenge on covert stakes", Financial Times (3 July 2008); J. Hughes, and J. Mackintosh, "FSA to impose derivatives disclosure", Financial Times (3 July 2008).

13.5 Conclusion

There is no doubt that derivatives offer huge potential for activist hedge funds to legally circumvent capital market rules due to the loopholes that can be descried in today's regulatory framework. Closing these loopholes by tightening the regulatory schemes governing the various transactions executed in the capital market place would certainly bring some relief as concerns the detrimental effects resulting from this type of rule manipulation. However, a stricter regulatory scheme may also cause the market place to lose some of its highly welcomed flexibility. Indeed, considering the fact that the vast majority of market participants use the derivatives environment for exactly the purpose it was intended to serve and also rely on market flexibility, rigid rulemaking may possibly end up doing more harm than good, that is, the cure may in fact be worse than the disease. Thus for the time being, capital markets will likely continue, albeit reluctantly, to provide activist hedge funds with the necessary tools for the lucrative exploitation of the strategic opportunities afforded to them by the current regulatory system

Chapter 14
Patents and Trademarks: From Business Law to Legal Astuteness

Boualem Aliouat

Abstract With regard to resource and skill theories, this chapter explores a new way of thinking about business law as it relates to Intellectual Property (IP) and patent and trademark law in particular. The author advances the concept of *legal astuteness* as articulated and developed by Prof. C. Bagley[1] as a means of exploring the nexus between managerial decisions of the firm and its IP legal environment. This chapter envisages IP law as a contingent component of the strategic project that can be optimised by *legal astuteness* and demonstrates how IP law can be both a resource and tool of value capture.

14.1 Introduction

Approaches to legal theory often incorporate the use of metaphors to help shed light on the subjacent logic that underlies legal practice. Indeed, the use of evocative language such as *game in law*, the *role of lawyers*, *legal actors*, *legal strategy*, *legal*

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[1]Constance E. Bagley's concept of "legal astuteness" emphasizes that the idea of legal strategy is increasingly concerned with identifying ingenious capacity and dexterity in business and law, rather than basic business/law strategic competencies or skills. Bagley develops a seminal and original approach in frame-working the changing perception of law – regarding it as a pragmatic portfolio of managerial tools or capacities which include, *inter alia*, advancing global IP projects, developing and performing legal audits, legal strategies and the management of litigation. See for example, C. E. Bagley, "Winning Legally: the Value of Legal Astuteness" (2008) 33(3) Academy of Management Review 378.

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engineering and most recently, *legal astuteness*,[2] is on the rise in business and legal discourse.

Specific theories such as the Game Theory of law,[3] the Resource-Based View of legal strategies[4] and the Knowledge-Based View[5] of legal intelligence (including those that examine tacit knowledge and other proprietary information) take these metaphors very seriously to the extent that they have contributed to the design of a new framework of law – one that is simultaneously normative and inventive, and factual and strategic. This framework takes into consideration, both internal and external elements of the firm as a quantifiable package of intentions, capacities, practices, risks and values. It enables the identification of new legal resources or capacities that can increase value capture and procure competitive advantage.

One approach that seems to encapsulate this emerging legal framework is a strategic model of intangible resources that combines the theories of knowledge,[6] core competencies[7] and resources.[8] This approach is largely represented in what can be described as a *Resource and Skill Theory* – a framework that links intangible resources and capabilities to sustainable competitive advantage. Based on current articulations of these models, a joint resource and skill approach would prescribe that firms position themselves based on their Intellectual Property (IP) resources and capabilities rather than on the products and services derived from those resources and capabilities. As described by Rumelt, the variance of profits within a specific industry is five to eight times more important than the variance of profits between industries.[9] Arguably, this observation supports the position that specific

[2]C. E. Bagley, "Winning Legally: the Value of Legal Astuteness" (2008) 33(3) Academy of Management Review 378, (2007) Yale School of Management (2007) 1–23, online: mba.yale http://mba.yale.edu/faculty/pdf/bagley_winningLegally_12_17_07.pdf [Bagley].

[3]See F. Ost, and M. Van de Kerchove, *Le Droit ou les Paradoxes du Jeu* (PUF, 1992).

[4]See J. B. Barney, "Firm Resources and Sustained Competitive Advantage" (1991) 17 Journal of Management 99; See also F. J. Mata, W. L. Fuerts, and J. B. Barney, "Information Technology and Sustained Competitive Advantage: a Resource-Based Analysis" (1995) 19 MIS Quarterly 487; See also Bagley (n 2).

[5]R. M. Grant, "Toward a Knowledge-based Theory of the Firm" (1996) 17 Strategic Management Journal 109 [Grant]; See also K. R. Conner, and C. K. Prahalad, "A Resource Based Theory of the Firm: Knowledge versus Opportunism, Organization" (1996) 7 Science 477.

[6]See Grant ibid; See also J. C. Spender, "Making Knowledge the Basis of a Dynamic Theory of the Firm" (1996) 17 Strategic Management Journal 45.

[7]See G. Hamel, and C. K. Prahalad, *Competing For the Future* (Harvard Business School Press, 1994).

[8]See B. A. Wernerfelt, "Resource-Based View of the Firm" (1984) 5(2) Strategic Management Journal 171; See also J. B. Barney, "Firm Resources and Sustained Competitive Advantage" (1991) 17 Journal of Management 99.

[9]See R. P. Rumelt, "How Much Does Industry Matter?" (1991) 12(3) Strategic Management Journal 167.

factors of and within firms are more important to competitive advantage than the effects of the overall market structure, particularly with respect to profits.[10]

IP strategies, in particular those related to patents and trademarks, tend to transverse the connections between legal and social systems. Although IP is unquestionably a source of value, it cannot be assumed that all firms will exploit IP as a growth opportunity or to gain a competitive advantage. While IP law offers innumerable and varied techniques to realise the value of knowledge, only some firms will take full advantage of these techniques and achieve success through actual strategies.

For example, Microsoft was able to obtain more than 90% of its margin by exploiting copyright law against unauthorised copies of its products.[11] Similarly, IBM captured its essential value through licensing fees and patent royalties.[12] However, Polaroid went further. Polaroid was able to use its patents in the instant camera market to create difficulties for Kodak to the extent that it was able to gain a significant competitive advantage[13] – post-dispute, Polaroid brought itself to a position where it simply had to await later companies to approach it with requests to enter into cross-licensing agreements.

Likewise, during the 1980s, in order to stimulate innovation and enhance the competitiveness of the high-tech industries, a process was implemented in the United States (US) to extend the scope of patentability – which nowadays affects current software[14] and business methods.[15] The patent "inflation" that followed generated adverse effects on the market, including the emergence of "Patent Trolls".[16] Here, law firms obtain a number of patents for speculative purposes.

[10]Competitive advantage depends on different macroeconomic conditions and different competitive positions, but also depends on different levels of operational effectiveness. See J. B. Barney, "Resource-Based Theories of Competitive Advantage: A Ten-Year Retrospective on the Resource-Based View" (2001) 27(6) Journal of Management 643; See also A. M. McGahan, and M. E. Porter, "How Much Does Industry Matter, Really?" (1998) 18(S1) Strategic Management Journal 15.

[11]See discussion in Bagley (n 2) 12; But note that although Microsoft has taken a heavy hand in dealing with piracy, it also recognises that piracy has its benefits – it can increase market share. In an interview with Fortune magazine, Bill Gates, Microsoft's Chairman mused, "It's easier for our software to compete with Linux when there's piracy than when there's not". See "Look for the Silver Lining. Piracy is a Bad Thing. But Sometimes Companies Can Turn it to Their Advantage", The Economist, (17 July 2008), online: The benefits http://www.economist.com/opinion/displaystory.cfm?story_id=11750492.

[12]See discussion in Bagley (n 2) 12.

[13]Ibid.

[14]Computer Software Copyright Act of 1980, Pub. L. No. 96-517, 94 Stat. 3015 (1980).

[15]*State Street Bank v. Signature Financial Group* (1998) 149 F.3d 1368, 1998. (Fed. Cir.).

[16]These trolls are mainly law and financial firms that acquire non-exploited patents (particularly in situations of business bankruptcy) and threaten the business users (mostly "big pockets") with legal actions and injunctions with the hope to negotiating financial compensation and avoiding trial. This is an area where judicial cases are rapidly growing. RIM, for example agreed to pay 612.5 million dollars to avoid being dragged into costly litigation for patent counterfeiting. See M. G. Plasseraud, "The Patent Trolls, Evil Spirits in the World of Patents" (2008) IRPI. The attack

This type of "parasitism" allows firms to obtain profits through the proliferation of dormant patent counterfeit actions. Thus, the threat of legal action or even just the potential for legal action can become highly profitable.[17]

The above examples suggest that astute business law activity is more than a systematic game or a rational strategy. It is thus the goal of this chapter to explore the zone between global corporate opportunities and legal strategies and articulate a conception of law found at the intersection of IP and *legal astuteness*.

14.2 Law as a Resource and Corporate Strategy

Recently, more and more companies are engaging in novel business activities. For example, it can be observed that Mattel is increasing investment in its brand reputation as demonstrated by the launching and operation of its own product-recall Web site. Additionally, major electronics manufacturing services (EMS) companies, like Sanmina-SCI – which do not normally require patent protection – are adapting their business models to include patent ownership and then are launching significant patenting and licensing efforts. What could be the reason behind engaging in such curious business activities?

The answer is likely the Law: Mattel was heavily criticised and continues to be met with disapproval, for putting over 20 million toys on the market which contained lead paint, a potentially dangerous toxin. With respect to the EMS companies, the adaptation to include patent ownership in the business model appears to be linked with the increasing economic value of patents.[18] These two

of opportunistic Patent Trolls is often a sign of a company operating in a strategic innovation area. Some of these patent hunters' victims are big companies which eventually negotiate and pay the premium required to exploit an acquired patent. The phenomenon is less common in Europe because the European Patent Office (EPO) and European States Patent offices have managed to maintain a high quality level of patents. However, patents known as "minefields" can be established by a competitor for the sole purpose of blocking potential development of its opponent. Similarly, "interference patents" which are copies of patents, can be filed shortly after original in order to cause distrust in patent office examiners and can delay acceptance for several years. Additional strategies can be observed in the dilatory strategies of pharmaceutical companies which seek multiple patents for the same drug (known as "clusters of patents") or open proceedings in dispute and litigation or else enter into agreements on patents in order to limit access for generic companies to the market, or finally, thwart national authorities when new competitors apply for approvals.

[17]See *MercExchange LLC v. eBay, Inc.* (2006) 547 U.S. 388 (USSC), where in 2006, the US Supreme Court, limited the forms of parasitism by submitting the permanent injunction to the four-factor test.

[18]The increase in the value of patents has been attributed to: the entry of new competitors like Original Design Manufacturers; the introduction of new laws – for example, a recent State Street bank decision affirmed the validity of US business method patents; and a new economic crisis brought about by the sustained downturn in both the telecommunications and computer markets. See M. Nowotarski, "Introducing Patents into a Major Service Industry" (2003) 38(1) Les

examples suggest that business strategy and business law are closely related. Thus, a manager's ability to use as many legal tools as are available when formulating and executing a firm's business strategy is significant to the strategic management and competitiveness of the firm.[19]

Most of the time, legal input, as a threat or opportunity, will come from the firm's environment in the form of a stake, a means of action and/or information available.[20]

The constraints imposed or illuminated by certain legal inputs (threats or opportunities) create situations where the firm is either in compliance or non-compliance. This in turn identifies a spectrum of strategic risks that will be decisive for a firm.[21] The level of risk varies with the capacity of the firm to exercise influence on its political and regulatory environment and, perhaps also, on the evolution of norms.[22] In this respect, firm compliance, along with its ethical behavior and reputation, can confer a level of legitimacy on the firm allowing it to contribute to the further development of its regulatory environment and consequently, shape the legal resources that it requires.

However, a firm's legal issues are not solely limited to the question of compliance or to preventive or defensive fields of action. On the contrary, legal rules, instead of being perceived of as mere constraints, are now recognised for their potential as a resource. Indeed external legal inputs can be used by a firm in such a way as to construct a legal self-reality by mobilizing the different resources provided by the law, for example, liberty of contracts (*lex contractus*), legal harmonisation, deregulation and so forth.

More and more firms are taking this legal risk and resource-based approach to business, which perhaps corresponds to and/or is evidenced by the increasing "judicialisation"[23] of the business world. The mobilization of law within the firm

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Nouvelles: Journal of the Licensing Executives 18, online: Markets, Patents & Alliances L.L.C. http://www.marketsandpatents.com/working%2001.html.

[19]See Bagley (n 2) 3–6.

[20]Ibid; See also T. Hinthorne, "Predatory Capitalism, Pragmatism and Legal Positivism in the Airlines Industry" (1997) 17(4) Strategic Management Journal 251; See also W.J. Henisz, and B.A. Zelner, "The Strategic Organization of Political Risks and Opportunities" (2003) 1(4) Strategic Organization 451.

[21]V.H. Fried, and B.M. Oviatt, "Michael Porter's Missing Chapter: The Risk of Antitrust Governance of International R&D Partnerships" (1989) 36(2) Journal of International Business Studies 175 [Fried and Oviatt]; See also M.S. Baucus, and D.A. Baucus, "Paying the Paper: An Empirical Examination of Longer-Term Financial Consequences of Illegal Corporate Behaviour" (1997) 40 (1) Academy of Management Journal 129; See also S.J. Frenkel, and D. Scott, "Compliance, Collaboration, and Codes of Labor Practice: The Adidas Connection" (2002), 45(1) California Management Review 1; See also P.S. Ring, G.A. Bigley, T.D'Aunno, and T. Khanna, "Perspectives on How Governments Matter" (2005) 30(2) Academy of Management Review 308.

[22]D.B. Yoffie, and S. Bergenstein, "Creating Political Advantage: The Rise of the Corporate Political Entrepreneur" (1985) 28(1) California Management Review 124; See also A.J. Hillman, and M.A. Hitt, "Corporate Political Strategy Formulation: A Model of Approach, Participation and Strategy Decisions" (1989) 24(4) Academy of Management Review 825.

[23]Increasing tendency in society to take legal action.

is thus no longer limited to preventive or defensive lines of action.[24] Indeed, the managerial field is increasingly approaching "the law" as a means to acquire competitive advantage and create strategic value.[25] Many working papers adopting a resource-based approach have demonstrated the processes by which legal input can influence strategic decisions as well as the role played by the legal variable in the performance and creation of longer-term competitive advantages or shorter-term advantages, as in the case of hyper-competition.[26]

14.2.1 Elements of a Resource-Based Approach

Pursuant to the resource-based approach, the first goal of a firm is to obtain the benefit of sustainable and defensible rents.[27] In order to achieve such result, a firm must obtain a competitive advantage. Competitive advantage (or value creation) can be achieved using a strategy based on cost advantage or differentiation advantage. Under a cost advantage strategy, the firm's objective is usually to become the lowest-cost producer in its industry, in certain markets or for certain products. In a differentiation advantage strategy, the firm selects a certain criteria demanded in the market and matches its production to specifically meet this criteria. In selecting its

[24]Perhaps not surprisingly, the legal variable has not been ignored by business research, particularly in its examination of the strategic management framework. See R. Amit, and P. J. H. Shoemaker, "Strategic Assets and Organizational Rent" (1993) 14(1) Strategic Management Journal 33.

[25]Consequently, in only a few years, the legal function has shifted from a simple support function into a central position with respect to the definition and implementation of differentiation strategies, innovations, external growth, internationalization, and governance structures. The evidence is that companies are increasingly incorporating lawyers in their various business activities, particularly those lawyers who are able to integrate situations both inside and outside the legal field. Indeed, the double curriculum of "Law and Management" has become particularly welcome in many institutions.

[26]A hyper-competition is the result of a complete renewal of the technologies and offerings, which oblige rules and standards to be adapted. Consequently competitors must constantly and intensively compete in price, quality or innovation in order to survive. See R. A. D'Aveni, *Hypercompetition* (The Free Press, 1994).

[27]"The concept of rent was first introduced by Ricardo (1817) as part of his endeavour to abolish England's Corn Laws. He identified that land on a mountain side varied in fertility depending on whether it was in the valley or on the mountain top. Thus, when demand was sufficient to make it economic to grow corn on less fertile land, high profits were earned by anyone owning very fertile land. These extra profits were called rents because they ultimately accrued to the landlord. The argument put forward by Ricardo was that the price of corn was determined by the supply of fertile land and not the level of rents. In other words, the achievement of above-normal rates of return or rents are achieved through valuable resources that are scarce. Whether rents are generated through valuable land, location advantage, patents, monopoly, high entry barriers or innovation, the central focus of resource-based strategies is on the continual search for rents". K. Chaharbaghi, and R. Lynch, "Sustainable Competitive Advantage: Towards a Dynamic Resource-Based Strategy" (1999) 37(1) Management Decision 48.

strategy, a firm must make sure to abide by and plan in accordance with its external conditions such as its brand name, market position, pricing policies, target markets and so forth.

Therefore, a firm producing luxury items is unlikely to utilize a cost advantage strategy. Similarly, if a firm has a mass production focus, it would be a dangerous decision to implement a differentiation strategy and produce only a limited volume of a certain item which in turn could lead to a decision to impose a higher price on customers to cover additional production costs.

Accordingly, questions such as the following should also be contemplated by a firm:

- Does the IP resource enable the firm to exploit an external opportunity or neutralise an external threat?
- Does the IP resource result in an increase in revenues, a decrease in costs, or some combination of the two?

In a resource-based view, in order to develop a competitive advantage, a firm must use resources and possess capabilities that are superior to its competitors. Resources are generally defined as an inventory of available factors, held or controlled by the firm[28] which serves the strategies of managers.[29] Resources that are assets which create value-added or other advantage in general, can be easily acquired by competitors as seen with, for example, patents, databases, know-how, etc.

Therefore, in order to be competitive, resources and competences must be able to defy ease of acquisition. This can be achieved by adhering to the following heterogeneity criteria:[30]

1. Immobility[31]
2. Ex-ante limitations: imperfections[32]

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[28]B. Wernerfelt, "A Resource-Based Theory of the Firm" (1984) 5 Strategic Management Journal 79.

[29]See Bagley (n 2).

[30]"A basic assumption of resource-based work is that the resource bundles and capabilities underlying production are heterogeneous across firms … One might describe productive factors in use as having intrinsically differential levels of 'efficiency.' Some are superior to others. Firms endowed with such resources are able to produce more economically and/or better satisfy customer wants. Heterogeneity implies that firms of varying capabilities are able to compete in the marketplace and, at least, break even. Firms with marginal resources can only expect to break even. Firms with superior resources will earn rents". M. A. Peteraf, "The Cornerstones of Competitive Advantage: A Resource Based View" (1993) 14(3) Strategic Management Journal 180 [Peteraf].

[31]Immobility leads to the creation of Ricardian rents or monopoly and relates to Resources that cannot be traded and/or are somewhat specialized to firm needs. See Peteraf ibid 183.

[32]"Prior to any firm's establishing a superior resource position, there must be limited competition for that [ex-ante] position … Without imperfections in strategic factor markets, where the resources necessary to implement strategies are acquired, firms can only hope for normal returns. Rumelt makes the point that unless there is a difference between the ex post value of a venture and the ex ante cost of acquiring the necessary resources, the entrepreneurial rents are zero. Profits

3. Ex-post limitations: substitutability and imitability[33]

Additionally, in order to be fully strategic, the resources employed must have a degree of alignment with the firm's external conditions in that the demands or challenges from its external circumstances is what dictates whether or not the strategy will be successful or even relevant.

Consequently, not all resources can be changed into a competitive advantage and of those that can, their ultimate mobilization will require a certain ability or capability within the management team and/or firm.

Capabilities can therefore be described as the techniques and strategies adopted by the firm in order to exploit and/or use its resources in the most efficient and effective way so as to gain advantage over competitors. Since the resources themselves are usually easily replicated or acquired, it is the firm's capability that remains the secret hand behind value creation and/or competitive advantage.

14.2.2 Transformation of Law, an Intangible, into a Resource

Law can be described as an organization science.[34] Managerial decisions are continuously being elaborated – they are taken and put into action in conformity and homogeneity with the firm's legal environment – a form of legal management.[35] On a larger scale, the same type of elaboration or indeed, subordination, can be observed with respect to the market economy and the law, whereby the law is elaborated by or subordinated to the market economy of the day. Similarly, the market economy is elaborated by or subordinated to politics. Although the economy's subordination to politics has now been occurring for centuries, it is also sometimes condemned by politics-related-law for the distortion of homogenous, transparent, free access market rules and the accumulation of wealth and at other times encouraged for the creation of value through the exploration of market advantages. Regardless, this condemnation or encouragement by politics-related-law tends to occur in reaction to an economic agenda or activity.

Accordingly, because the function of law is dictated by economic endeavors, law cannot build itself as an autonomous and coherent system. There is no doubt that the impossibility for law to achieve this result is what allows for its strategic

come from ex ante uncertainty". Peteraf ibid 185. A lack of price flexibility constitutes an example of ex-ante limitation.

[33]The idea here is that in order to maintain a superior position, there must be forces that limit subsequent competition for rents achieved. Substitutes make monopolist or oligopolist demands more elastic thereby reducing rents. Imitability concerns factors that protect firms and their rent streams from imitation. See Peteraf ibid 182.

[34]J. Paillusseau, "Le Droit est Aussi une Science d'Organisation" (1989) 42(1) RTD Com. 9.

[35]C. Collard, "Le Management Juridique, une Nouvelle Pratique du Droit dans l'Entreprise" (2005) Entreprise Ethique 22.

instrumentation (or manipulation), notwithstanding that such instrumentation will eventually be subjected to certain limits.[36]

Consequently, law can be transformed or expanded from a mere protection for the assets of a firm to a resource with multiple potentials: financial; strategic; substantial; and institutional, all of which play a significant role in the firm's value chain.

Indeed, legal resources can bring security and flexibility in a context of strategic alliance, partnership, and cooperation.[37] Similarly, a firm can acquire a legal structure adapted to its objectives and organized on the basis of relationships between its board, stockholders and other stakeholders.[38] These legal resources are also determinants in innovation-based strategies (whether they have a commercial or technological nature) by providing, for example, protection for innovation or distribution.[39]

For Roquilly legal resources can be divided into the following two categories:[40]

- Resources "objects": those that generate rights (for example, rights of intellectual property, contracts, social structures, etc.) enforceable in court and whose role is to preserve, capture, and develop the value of other resources of the firm[41]
- Resources "know and know-how": those held by legal experts

[36]A. Masson, "Le Paradoxe Fondateur des Stratégies Juridiques, Essai de Théorie des Stratégies Juridiques" (2008) 1 Revue de la Recherche Juridique – Droit Prospectif 443.

[37]B. Aliouat, and C. Roquilly, "Projets d'Innovation et Gestion des Risques: les Stratégies d'Innovation dans une Perspective d'Ingénierie Juridique" (1996) 3 Gestion 2000 135; See also J. Hagedoorn, and G. Duysters, "External Sources of Innovative Capabilities: the Preference for Strategic Alliances or Mergers and Acquisitions" (2002) 39(2) Journal of Management Studies 167; See also J. Hagedoorn, D. Cloodt, and H. Van Kranenburg, "Intellectual Property Rights and the Governance of International R&D Partnerships" (2005) 36(2) Journal of International Business Studies 175.

[38]C. Sundaramarthy, J. M. Mahoney, and J. T. Mahoney, "Board, Structure, Antitakeover Provisions, and Stakeholder Wealth" (1997) 18(3) Strategic Management Journal 231; See also P. J. Lane, A. A. J. Cannella, and M. H. Lubatkin, "Ownership Structure and Corporate Strategy: One Question Viewed From Two Different Worlds" (1999) 20(11) Strategic Management Journal 1077; See also L. Poppo, and T. R. Zenger, "Do Formal Contracts and Relational Governance Function as Substitutes or Complements?" (2002) 23(8) Strategic Management Journal 707.

[39]P. C. Grindley, and D. J. Teece, "Managing Intellectual Capital: Licensing and Cross Licensing in Semiconductors and Electronics" (1997) 39(2) California Management Review 8; See also V. Denicolo, and L. A. Franzoni, "Patents, Secrets, and the First Inventor Defense" (2004) 13(3) Journal of Economics and Management Strategy 517; See also A. Arora, and M. Ceccagnoli, "Patent Protection, Complementary Assets, and Firm's Incentives for Technology Licensing" (2006) 52(2) Management Science 293.

[40]See C. Roquilly, "La Construction des Resources Juridiques au Service de la Création d'Avantages Concurrentiels Durables" (28–31 May 2008) AIMS Conference [Roquilly].

[41]G. Pisano, and D. Teece, "The Dynamic Capabilities of Firms: an Introduction" (1994) 3 Ind. Corp. Change 537.

Legal resources can also be shared.[42] For example, network industries can generalise standards in order to benefit certain firms. Of course, the mere imposition of a standard can lead to a loss of exclusivity with respect to the technologies involved, but the firms at the origin of the standard can obtain at least one advantage – anticipation over future market developments.[43]

Thus, the deficiency of the law sets the stage for transforming what are supposed to be constraints into opportunities. Opportunities exist however only insofar as they can be recognised.

In order to achieve a competitive advantage by mobilizing its legal resource, a firm must first determine the position of legal resources on its value chain so that it can be effectively exploited. The firm must also take into consideration, the potential interaction of such a contemporary strategy with the court.

Additionally, the firm must pay attention to the legal environment and the strategies implemented by competitors.[44] For example, a firm that wishes to develop its IP legal astuteness capacity for IP should measure its performance distances[45] with respect to the opportunities and threats offered by the environment and in regard to different legal variables such as: the degree of IP legal certainty; degree of trust assets; law and freedom; degree of legal transparency; political risk and legal risk. Measuring performance distance assists in illustrating the incentives offered by and the strategic orientation of a given legal system. It also underlines the sum of efforts required for a specific and hypothetical firm to exploit the best opportunities available in a given sector.

Moreover, legal resources need to be combined with the development of a legal capacity, to lead to real economic advantage. Indeed, a legal resource can only be turned into legal capacity when a firm is able to integrate and transform the data or inputs from the legal environment into new legal resources[46] such that what might

[42]That being said however, it is still important to remember that the obtaining of rights is the result or source of a major antagonism or conflict with the other interests at stake. Consequently, a firm should consider all other interests (for example, competitors, regulatory bodies, etc.) that could become involved when a legal resource is mobilized. Fried and Oviatt (n 21).

[43]R. Garud, and A. Kumaraswamy, "Changing Competitive Dynamics in Network Industries: an Exploration of Sun Microsystems' Open Systems Strategy" (1993) 14 Strategic Management Journal 351.

[44]The risk of legal action also influences a competitor's strategic choice. Externalization activities, for example, through concessions or licenses will no doubt be preferred to internalization by acquisition as the licensed firm will bear the liability for the licensing company.

[45]Note however that the performance of a process is hardly measurable. The only way to measure is through the use of a benchmark applied to those of the competitors. The difference between its own process and this benchmark is called a "performance distance". See R. Camp, *Benchmarking: The Search For Industry Best Practices That Lead To Superior Performance* (ASQ Quality Press, 1989).

[46]The notion of environment here concerns any form of rules including those coming from the legal environment (law, rules, case law), the industrial environment (professional norms, codes of good conduct) and the competitive environment (property rights and contracts held by competitive firms). See Roquilly (n 40).

have been a constraint becomes an opportunity.[47] The possibility of utilizing IP law to create resources out of trademarks, patents, designs or models is but one example of how a firm can create opportunities to move itself from a marginal situation to a market power situation.

Firms are now aware that the development of a legal resource "portfolio" can contribute to the creation of value.[48] Indeed, legal resources are, perhaps even more so, in the context of exacerbated competition, a significant component of strategic management and in the cultivation of *legal astuteness*.[49]

14.2.3 Law Resources in the Strategies Formulation Process

As discussed earlier, the law is often behind the implementation of innovative business strategies which are also impacted, influenced or driven by the firms resources and competences and its appreciation of them. It can also be observed that legal decisions are usually connected to a firm's long term development. This connection can be expressly conceived of as a form of *Business Law Engineering*[50] which is both a mindscape and a problem-solving method at the law and business interface and includes many tools and components as oriented by the firm's strategic objectives.

Business Law Engineering transforms constraints that arise out of the deficiency of the law into opportunities through its application of two fundamental data: (1) the consideration of possible fields to manage; and (2) the strategic intentions of managers. First, the identification of possible fields to manage is built up through establishing several sets of possible hypotheses, which are scalable to accommodate for in-progress in-conflict environments. Business law engineering thus develops elements for problem-solving and management adaptability.[51] Second, because opportunities can only exist if they can be recognised, opportunities are necessarily

[47]S. Maijoor S. and A. Van Witteloostuijn, "An Empirical Test of the Resource-Based Theory: Strategic Regulation in the Dutch Audit Industry" (1996) 17 Strategic Management Journal 549.

[48]See Bagley (n 2).

[49]C. E. Bagley, "What's Law Got to Do With It: A Systems Approach to Management" (2006) Harvard Business School Working Paper 06-038, online: hbswk http://hbswk.hbs.edu/item/5415.html.

[50]See J. Barthélémy, "Business Law Engineering: a Concept" (1993) *JCP éd. E*, suppl. No. 2 Cahiers de Droit de l'Entreprise; See also B. Aliouat, and C. Roquilly, "Business Law Engineering", *Ten Key Tools to Manage* (Management Press, 1996).

[51]Business law engineering arises from a strategic platform and involves anticipating constraints and taking advantage of emerging opportunities. Here, the methods used to match the technicality of the law and the business targets – implementation of processes and methods of analysis – are similar to those used by scientific engineers. The methods utilized typically include several phases: (1) identification of purposes; (2) perception and identification of the need for law management; (3) the setting of targets; (4) consideration of organizational constraints; (5) identification of techniques to be used; (6) alternatives; and (7) implementation of techniques.

connected to managerial intention and an understanding of the law. Indeed, *Business Law Engineering* cannot be content with a positivist view of law. Its success depends on the attitude of lawyers and managers attune to the risks and opportunities of the environment. Legal instruments must be designed to fit with strategic business objectives – illuminating the development of a kind of legal "astuteness".

Bagley defines *legal astuteness* as a "valuable managerial capability that may provide a competitive advantage under the resource-based view of the firm".[52] According to Bagley, the managerial capability legal astuteness includes four key components:[53]

1. A set of value-laden attitudes about the importance of law to firm success
2. A proactive approach to regulation
3. Ability to exercise informed judgment in legal aspects of business management
4. Appropriate use of legal tools and context-specific knowledge of the law

Legal astuteness or intelligence is therefore achieved through a proactive identification of fields of management from the firm's environment such that the fields and their respective elements can be transformed into capability through context-specific problem-solving and management adaptability.

While the potential conflicts revealed from such an analysis can often be resolved by such an audit, it is also important to keep in mind the connections existing between legal and non-legal issues. A strict management problem can often be solved by legal means, and conversely, a law problem can necessitate managerial solutions larger than those arising from the juridical sphere.[54]

Hence, it might be observed that one of the major aims common to both *Business Law Engineering* and *legal astuteness* is the rationalisation of the firm's actions in respect of the law, so as to allow the firm to capture value for the ultimate profit of shareholders and perhaps also stakeholders. No manager can successfully ignore the legal dimensions to business, and everyone in the firm is charged with their management. For example, when Mattel did not have sufficient quality control procedures in its supply chain to compensate for the extra risks related to outsourcing to relatively new Chinese subcontractors, it was previously observed that business law and strategic management worked in tandem to save Mattel's brand reputation. Thus, lawyers (who are not necessary risk averse) and managers are challenged to match the legal aspects of business problems with broader business objectives. This challenge can reveal some interesting questions. For example, what

[52]Bagley (n 2) 3. The relation between the concept of *legal astuteness* and the one of *legal capability,* sometime used in management, can be explained by the fact that the legal capability is similar to dynamic capabilities founded on deliberate learning to make difference in constructing competitive advantage anchored in legal resources.

[53]Ibid.

[54]For further discussion see B. Aliouat, and C. Roquilly, "La Veille Juridique pour une Intelligence des Situations Stratégiques" (1994) 148 Les Petites Affiches-La Loi 10.

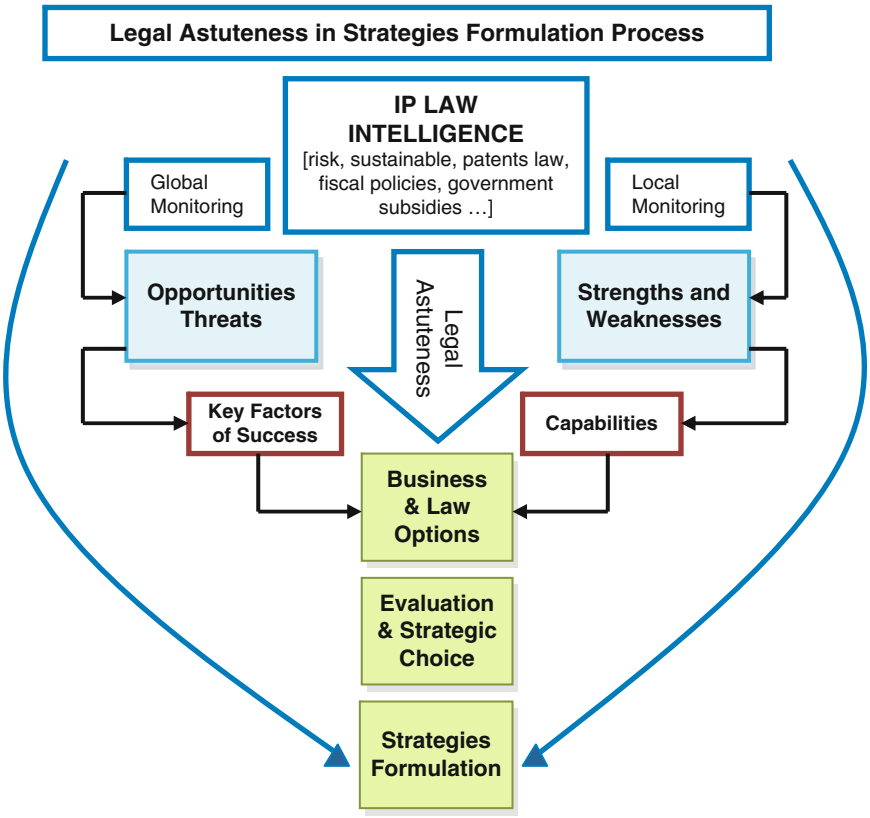

Fig. 14.1 Legal astuteness in strategies formulation process

do trademark, trade secret and patent law mean for business? Are they simply a corpus of defensive protections or can they be an offensive source of value?[55]

Figure 14.1[56] illustrates how legal astuteness can be expressly integrated into the business reflection and influence the formulation of strategy.

The different steps for the formulation of strategies that incorporate the concept of legal astuteness can be summarised as follows:

[55]IP law can be used for more than a simple tool or asset for preservation – it provides many opportunities to capture value and enhance competitive advantage. However, it should not be viewed as the only tool of value. Rather, the strategic approach recognizes that the law is simply part of a corpus of "astuteness" that can be used both as a resource for the management and as part of its value chain.

[56]Original diagram based on a basic SWOT (strengths, weaknesses, opportunities, threats) view. See T. Hill, and R. Westbrook, "SWOT Analysis: It's Time for a Product Recall" (1997) 30(1) Long Range Planning 46.

14.2.3.1 Inputs

By a permanent monitoring of the legal data compiled based on a legal intelligence approach to its environment, a firm can identify the legal resources available. However, this preliminary identification of legal threats and opportunities/strengths and weaknesses requires accurate information to enable the testing of activities through key performance indicators. Consequently, the development and maintenance of a law intelligence is required for extracting specific data for production of the indicators needed[57] and the structuring data within the data warehouse. This pre-processing allows analysis tools to access them more easily.

14.2.3.2 Legal Astuteness

Information provided by law intelligence is aligned with all factors (for example, technologies, policies, laws and regulations, etc.) that might assist in coming to the formulation of a strategy in order to achieve an ingenious capacity and an original combination of key legal factor of success.

14.2.3.3 Outputs

- Business and Law options: when a more or less complex problem occurs, lawyers analyse the request, mobilize legal astuteness and compare the data in order to generate the desired indicators and provide a list of options (or opportunities) available.
- Evaluation and strategic choice: lawyers disseminate, condense and present to the decision maker, the value-added information generated in its most readable form.
- Strategies formulation: the manager takes into consideration the choices available and formulates the firm's general strategies.

14.3 IP and Strategic Problem Solving: Capturing Value and Competitive Advantage

In this section, intellectual property strategies are analysed from the perspective of addressing the firm's global problems or issues with respect to IP. To this end, a methodology to assess the firm's IP legal astuteness when it formulates its strategies is proposed. The overall objective of this section is to provide comment on how the application of legal IP is progressively moving from simple business law models to

[57]It retrieves this data and centralizes in a particular database.

considerations of legal astuteness through the use of managerial tools and strategic approaches.

14.3.1 IP Legal Astuteness: A New Strategic Resource

As with the law, a firm's perception is influenced by historical, economical, cultural and sociological contexts. Indeed, any economy has a history and a firm's perception is often the result of that economical history which is also subject to interpretation via managerial representations.[58] The firm's consideration of its own business from the perspectives of international development, technological leadership or profit maximising, can lead to certain representations which in turn might be altered by management representations requiring different decisions or actions. Be that as it may, a manager should nonetheless envisage business law beyond the simple compliance paradigm and instead perceive and utilize it as a means to actively increase firm value.

For example, IP law can be considered as a center of benefit, a value chain, and/or a knowledge process. Each of these three approaches underlines the positive role that IP law can play in firm performance.

For example, as discussed earlier, to secure competitive advantage, even just temporarily, an IP resource must be valuable and rare. Indeed, IP strategies only create value if there is a real competitive advantage. It is the rareness of the IP resource that makes it difficult for other competitors to obtain it or to imitate. Indeed, intangible resources such as brands and intellectual property rights tend to be more costly to imitate than tangible resources. Further, an IP resource must be rare to the extent that perfect competition has not set in. For example, an IP resource can be strengthened by firm reputation – Harley-Davidson's styles may be easily imitated, but its reputation is not.

A large variety of strategies should be able to be adopted in relation to IP law and resources.[59] If strategies based on trademarks and patents can be animated by the above noted logics of differentiation, they should also be able to be animated by the creative will to gain additional forms of competitive advantage, or in other words, through *IP legal astuteness*.

Corporate IP strategies are rarely solely aimed at one static target, for example, asset preservation, capture of value or competitive advantage. Dependent on the given circumstances, at different times, one objective might take priority over another. Still at other times, decision-makers might choose to invest on reputation

[58]G. Morgan, *Images of Organization,* (Sage, 1997).

[59]Although IP resources are intangible assets, concrete representations of IP as a resource can be achieved by using, for example, graphic representations or through reference to concepts such as accessibility and origin. Indeed, strategic business development attaches distinctive attributes to intangibles to allow for the capture of over-value or returns from situations arising out of the differentiated character of a firm's products and services.

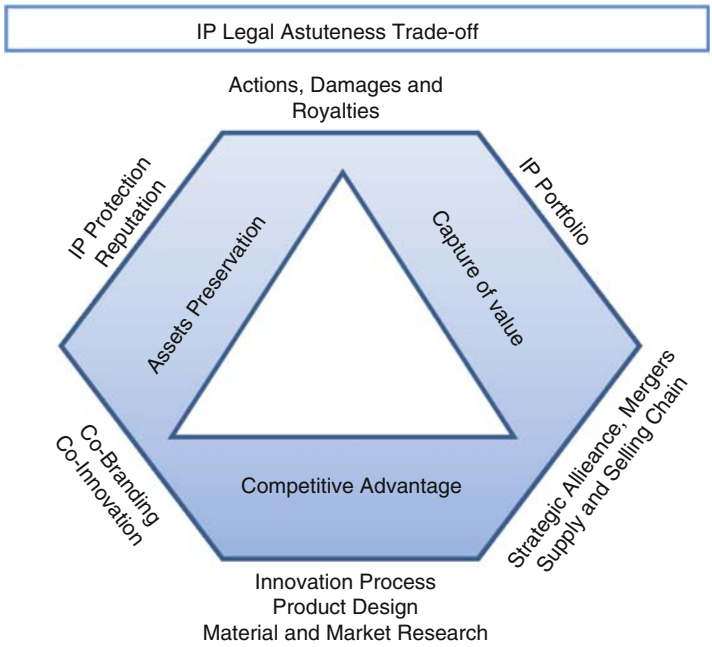

Fig. 14.2 IP legal astuteness trade-off

and innovation, or protection and co-innovation for example. IP management and decision-making involves variable balancing and trade-offs – the more consideration given to the trade-offs, the more legally astute. Figure 14.2 summarises the implications of *IP legal astuteness* to firm strategy.

Legal astuteness involves the recognition that IP rights offer more than just asset preservation. IP rights can offer support for many other varied strategies including: technological leadership; globalisation; differentiation;[60] or exploitation of competitive stability areas.[61] Indeed, trademarks, signs, domain names, designs, models and patents can all be used to achieve, to the advantage of the firm, an imperfect market situation whereby the products become less important than image and

[60]This differentiation can take a different form. For example, trademarks can be nominal, figurative or in the form of a sound. The most varied sources of communication (television, radio or internet) become supports of distinctive trademark valuation and enrich the potentialities of firms' differentiation.

[61]These are opportunities for competitive truce between competitors who practice avoidance strategies or strategic alliances. See M. Porter, "Changing Patterns of International Competition" (1987) 28(2) California Management Review 13; See also B. Aliouat, *Les Stratégies de Coopération Industrielles* (Economica, 1996).

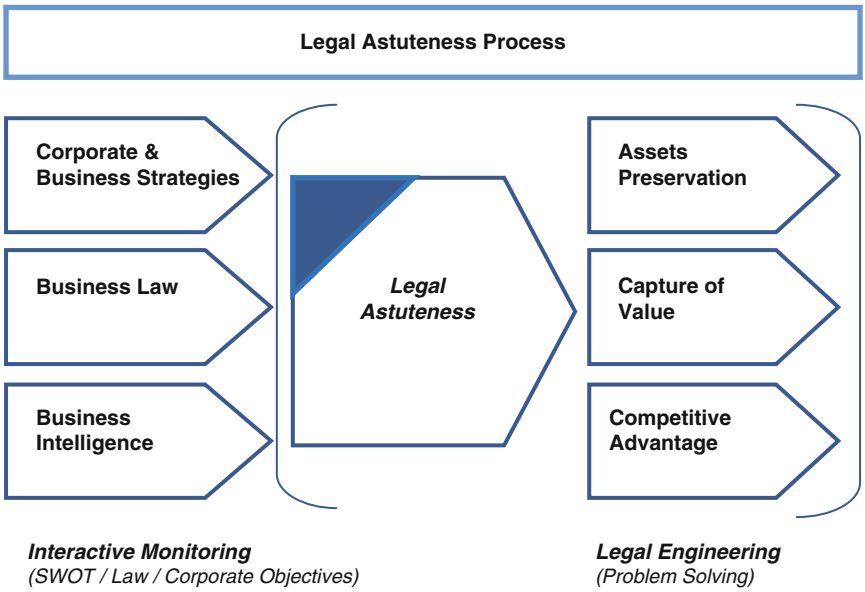

Fig. 14.3 Legal astuteness process

so-called "intellectual property".[62] In other words, intellectual property can become an exclusive source of (albeit for the most part temporary), competitive advantage.[63]

14.3.2 IP Legal Astuteness Process for Competition

The construction of a legal astuteness capacity requires that the firm consider both upstream and downstream objectives. That is, legal astuteness requires a consideration of typical corporate objectives and factors for success such as those related to competence, law and intelligence as well as problem-solving objectives such as those related to asset preservation, value capture and competitive advantage (Fig. 14.3).

[62]In an imperfect market situation, such firms will enjoy a situation where they won't have to suffer from unfair or parasitical behavior as intellectual rights will give them exclusivity over their image.

[63]This intangible resource is not frozen. The non-usage, the operation default, the degeneration or the generalisation of usage, or even deceptivity (which is the consequence of a competition based on differentiation by reputation) or a shift in a key technology could lead to the loss of a resource. See B. Aliouat, "L'Évaluation de la Depreciation de la Marque: un Obstacle à la Gestion d'un Portefeuille de Marques" (1995) 4 *Gestion 2000*.

A legal astuteness approach thus takes into consideration a wide number of variables and does not limit analysis to one dimension or one rationale. The economic, political, social, environmental, management, technological or legal all constitute different dimensions of a single strategy which all need to be assessed.

Such an approach can assist firms in gaining an understanding of the evolution of their environment. For example, in ascertaining why the value of US patents for global service companies is increasing, one should consider IP laws, patents policy, innovation methods and the business environment. This mode and scope of consideration will identify, as described earlier in this chapter, that the increasing patent activity of the manufacturing services industry is due to, for example, the entry of new patent-intensive competitors, new patent laws (for example, the possibility of patenting business methods) and a new economic crisis which has forced the industry to expand and modify its business model.

Indeed, IP legal astuteness is such a key element to the creation of value that the managerial principle of the balanced scorecard can be applied to it.[64] While the financial performance of an organization is essential for its success, it is not the only factor relevant to capturing value. The balanced scorecard model is part of a performance management system that enables organizations to implement the company's vision from four perspectives – financial, customer, business process (internal perspective) and growth and learning. For each perspective of the balanced scorecard, objectives, measures, targets and initiatives are monitored and scored. This approach generates a plural vision of firm performance such that value is overlapped and maximum value captured.

[64]In the specific context of the firm's value creation, this pattern introduced by Kaplan and Norton is now a popular tool to visualize relationships between intangible performance drivers and outcome objectives. See R. Kaplan, and D. P. Norton, *Strategy Maps – Converting Intangible Assets into Tangible Outcomes* (HBS Press, 2004). See also R. Kaplan, and D. P. Norton, *L'Alignement Stratégique: Créer des Synergies par le Tableau de Bord Prospectif* (Eyrolles, 2007). According to resource-based view of the firm, resources exist as an indivisible bundle which impacts performance with causal ambiguity. See, S. A. Lippman, and R. P. Rumelt, "Uncertain Imitability: An Analysis of Interfirm Differences in Efficiency Under Competition" (1982) 13(2) Bell Journal of Economics 418. So, it is neither easy nor possible to identify how an individual resource contributes to performance or success without taking into account interdependencies with other resources. Following the same logic, legal resources or other intangible resources are suggested as intangible value drivers in embedded strategy maps. The balanced scorecard model, based on four perspectives, gives organizations a better understanding of how their intangible and physical resources are interdependent on each other to create capacities, competencies, value and competitive advantage. For example, producers of mobile phones cannot obtain a competitive advantage without exploiting embedded intangible and physical resources such as: technological and network innovation; supply and selling chains; trademarks (Samsung,...); brands (U600,...); slogan ("Connecting people"); patents (electronic network, manufacturing process,...); copyright (ring-tones, pictograms, animations,...); database protection (repertory); designs (boxes, keys,...); topography (integrated circuits); and know-how in conception and manufacturing.

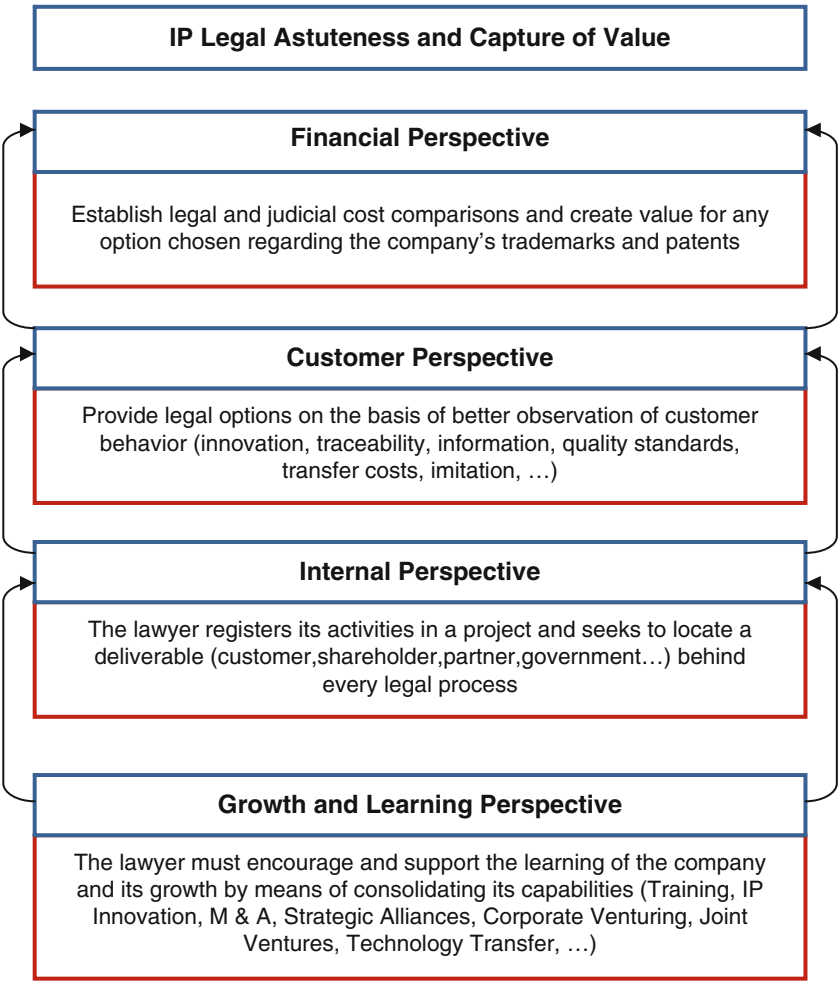

Fig. 14.4 IP legal astuteness and capture of value

Figure 14.4 illustrates IP legal astuteness from the perspective of a balanced scorecard model. It shows also how organizational, financial, business and legal resources might be interconnected to create or capture value.

A good example of achieving over-lapped value is demonstrated by the activities of the France-based, multinational firm "Caddie" which has developed more than 200 models of trolleys. Through its designs and models, Caddie has acquired a very profitable leadership in this industry, creating stable value for its stockholders. The firm developed notability throughout the world for its trademark policy – by realising high turnovers, the firm was able to control costs and in turn dominate

the rising market. Through its patent practices,[65] Caddie was able to consolidate its market leadership and raise strong entry barriers.

A counter-example is that of the Swiss company, MMS, which holds the brand for the "Micro" scooter and kickboard. MMS was surpassed in the market by the highly successful American firm, JD Corp. which used MMS technology in developing a brake system similar to that of MMS. In a sector of ultra-short industrial cycles and growing demands, the technology strategy deployed by JD Corp. allowed it to mark its leadership. MMS failed to build a key intellectual property asset – such as design property or brand image – whereas JD Corp. invested in its intellectual property and developed commercial leadership in the USA. The development of a plural vision of the company through legal astuteness might have revealed strategic recommendations for MMS, for example, the development of strategies related to image management. One such strategy could have been to invest heavily in its advertising in order to turn "Micro" into a trademark such that JD Corp. could be sued for infringement of their patent.

D. Danet[66] provides an interesting case concerning the use of IP rights and image management. Two companies, Leclerc and Alfer, launched websites containing online price comparisons in order to gain consumer support. During the advertising campaign, which followed the launch of their respective websites, both firms were sued but the tactical results were identical: while they both lost their trials and fined in the range of €35–40,000, they both benefited from "free" mass-media coverage.

However, the strategic results within the firms were opposed. While Leclerc viewed the campaign as a success, Alfer did not, resulting in the dismissal of its management team.

This example illustrates that the law cannot be instrumentalised and used as a tool of strategic communication when there is an absence of a solid legal strategy within the firm and which is not integrated in the firm's global strategy and carried out by the firm's top managers. Indeed, in order for a legal strategy to be a success for the firm, jurists must interfere upstream, taking into consideration the firm's global strategy and working with communication teams. Effective legal strategies that serve the firm's objectives cannot be created unless managers make the proper connections. That is, managers must associate business intelligence, corporate strategy and legal astuteness in a global approach as demonstrated by Table 14.1.

[65]The firm has deposed more than 150 patents in the world. Empirical observation in INPI Report (Paris, 2008).

[66]D. Danet, "Au Croisement du Management Stratégique et du Droit: la Stratégie Judiciaire des Entreprises" (2007) Journée de Recherche "Stratégie et Transversalité", Université de Nice Sophia Antipolis.

Table 14.1 IP legal astuteness and corporate strategies

IP business intelligence	Corporate strategy	Legal astuteness	Business case
Growth of technological innovation ruptures on the market	Access to new resources and protect our technological innovations and know-how	Strategic alliances contracts with non-poaching clauses	Electronic industries
Lower barriers to entry and restrictions on imports of Chinese products	Protect our innovations against possible low-cost imitations	Investing in the judicial protection of brand products and contract joint ventures with Chinese partners	Mass-market products, low and middle tech
Based on a new law about design patents, a new form of competitors emerging on the manufacturing services industry (Original Design Manufacturers)	Major companies have to maintain their leadership	Gradually replace OEMs contracts with majors through acquisitions or corporate venturing contracts with ODM industry	Electronic manufacturing services industry (with many converging technologies and practices)
The outsourcing of production creates quality control and ethics problems	Preserve the image of products and brands	Establish cell communication and effective quality	Outsourcing in China
Activities portfolios are quickly outdated	Companies must maintain their market and their rents	Firms develop deal structures and specific IP contracts between firms which discover technologies and those which develop them	Licensing agreement in pharmaceutical business development
The market is hyper-competitive and experiencing important technological innovation disruptions	Key factors of success suggest anticipations over future developments to maintain a competitive advantage and rents	"Champions" impose a standard often at the expense of maintaining exclusive rights to the technologies involved	New competitive dynamics in network industries (the case of Sun Microsystems' open systems strategy)
The market is open to competitors and sources of differentiation are limited	Reveal an artificial differentiation on common standards to maintain capture of value	Systematic legal action against all competitive initiatives or imitations of IP resources	Motorola systematically attacks the manufacturers of standard batteries and communicate in parallel the dangers of "counterfeit batteries"
Extension of patentability scope Proliferation of patents	Protect innovations and profits of patent portfolios	Lobbying Transaction negotiation Focus on essential patents	Computer Software Copyright Act 1980 and *CAFC-State Street Bank*

(*continued*)

Table 14.1 (continued)

IP business intelligence	Corporate strategy	Legal astuteness	Business case
	Develop proactive strategies face to the threat of the emergence of Patent Trolls and Sponges getting benefit of patent system failures	IP scanning and legal failures Monitoring Business intelligence Startup acquisitions Strategic alliances	*v. Signature Financial Group* (1998) 149 F. 3d 1368 *MercExchange LLC v. eBay Inc.* (2006) 126 S. Ct.1837 RIM agreed to pay 612.5 million dollars to avoid being dragged into a costly litigation for patent counterfeiting *Transocean Offshore Deepwater Drilling Inc. v. GlobalSantaFe Corp.* (2006) WL3813778 (SD.Tex.)

14.4 Conclusion

Intellectual property has become a strategic weapon and a decisive key of value creation, not only for innovative or co-innovative firms, but also for firms which are implicated in parasitic innovation.

Patents and Trademarks strategies are typical examples of legal resources that can be exploited to build a competitive advantage. Indeed, IP law offers a large range of strategic alternatives which can be optimised by *legal astuteness*.[67]

In the new legal theory, the recent metaphor of "legal astuteness" enlightens the subjacent logic of IP law practices and strategies. Managers' current attitudes toward the legal dimensions of business suggest more and more cooperation with lawyers and the strategic integration of legal opinion and law.

This reality contributes to the design of a new framework surrounding the role of legal sources in business: new legal resources or capacities predisposed to capture value and procure competitive advantage.

[67]The abusive use of patent law for example, as a tool or an instrument, nowadays presents an unprecedented threat, especially with the significant decrease of such cases during the last few years (in 2007, 156,100 worldwide patents have been filed). World Intellectual Property Organization Report (21 Feb 2008). Several explanations have been offered for this observable fact:

- The arrival of emerging countries in global markets
- The importance of exploring research for disruptive innovations
- The importance given to innovation in competing with low costs firms
- The increasing number of start-ups
- The growing interest for protecting innovations and profits of patent portfolios by erecting barriers to market entry
- The extension of patentability scope to software and business methods, and the proliferation of patents granted by the US Patent Office
- The emergence of patent trolls, or patent hunters or spongers, getting benefit from patent system failures
- Growth opportunities for licensing

It would be judicious to identify the legal environment as a complex ecosystem where companies adopt hegemonic, competition, mutualism, symbiotic, or parasitic behaviors. However, it is well-observed that in anticipation of the reforms of the US Patent Act and the review of the United States Patent and Trademark Office procedures as to limit these failures and abuses, powerful lobbies compete to minimize the harmful effects of parasitism and delayed IP strategies by patent revocations, jurisprudence evolution and legal reform orientation.

Chapter 15
The Strategic Use of Legal Margins: How to Introduce an Extension of Someone Else's Brand

Ross D. Petty

Abstract This chapter examines the legal issues associated with offering what might appear to consumers as a brand extension of a brand owned by someone else. It identifies four possible strategies for associating with a famous brand: brand resale, compatible products, imitative substitutes and parody products. It also examines how various judicial trademark decisions in the United States of America and the European Union have addressed these tactics. The chapter concludes with strategy recommendations for marketers.

15.1 Introduction

Out of the multitude of brand management books and articles available today seemingly arises the widespread recommendation that marketers develop, in the minds of consumers, distinctive and strong brand identities for their products and services in order to avoid the harsh price competition of undifferentiated commodity products.[1] Implementing such a recommendation however, is easier said than done. Not only is developing a distinctive brand difficult and subject to erosion over time, but 90% of new brand introductions fail.[2] Furthermore, advertising is less

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[1]For example see D. Aaker, *Building Strong Brands* (The Free Press, 1996); D. Lock and N. Farrow eds., *The Gower Handbook of Management*, 4th ed (Gower Publishing, 1998) 437–460; See also D. Wengrow, "Prehistories of Commodity Branding" (2008) 49(1) Current Anthropology 7–34; See also P. F. Anderson, and P. D. Bennett, *Dictionary of Marketing Terms* (American Marketing Association, 1988); also see K. L Keller, *Strategic Brand Management: Building, Measuring, and Managing Brand Equity*, 3rd ed. (Prentice-Hall, 2003).

[2]M. Landler, Z. Schiller, and L. Therrien, "What's in a Name? Less and Less" (8 July 1991) Business Week 66.

A. Masson and M.J. Shariff (eds.), *Legal Strategies*,
DOI 10.1007/978-3-642-02135-0_15,

effective for unfamiliar brands compared to familiar brands.[3] For these reasons, launching a new brand has been estimated to cost about $150 million in some consumer markets.[4] According to branding guru Kevin Lane Keller:

> Today's challenging and unforgiving marketplace makes brand building difficult. Fickle consumers, intense competition, demanding retailers, constrained resources, and impatient investors put unparalleled pressure on marketers to skillfully design and execute their programs. As a result, marketers welcome any means toward helping them build brand equity and value.[5]

One alternative that decreases the risk and expense of a new brand introduction is to launch an extension of an existing brand. Recent estimates suggest that as many as 80% of new product introductions are brand extensions – slightly modified products (e.g., TIDE with bleach) that use one or more pre-existing brand names. Aaker and Keller note that extending a well-known brand name may make promotional expenditures more effective.[6] Of course even the use of a brand extension does not guarantee success. About 80% of brand extensions in many fast moving consumer goods categories fail.[7]

The use of previously developed brand assets is obviously dependent on either owning those brand assets or having access to them. While seeking a license is always possible, brand owners may be reluctant to grant a license without both high fees and a high degree of quality control over the licensed product. Furthermore, even when a license is granted, things often do not go smoothly and parties can end up in expensive litigation over whether, for example, licensing terms are being followed.[8]

This chapter suggests that if a license or purchase of an existing brand is not available under affordable terms, an alternative tactic that might be considered is to offer a product using an unlicensed brand extension of someone else's brand. Even when carefully executed, this tactic can engender some legal risk under trademark law, however, in many cases, the expected costs of legal challenge may be outweighed by the increased effectiveness and savings of permission costs. Trademark law, like other forms of intellectual property laws, seeks to provide incentives for innovative products by offering some degree of exclusive legal rights to the

[3]M. C. Campbell, and K. Lane Keller, "Brand Familiarity and Advertising Repetition Effects" (2003) 30(Sept) Journal of Consumer Research, Inc. 292–304.

[4]D. A. Aaker, and K. Lane Keller, "Consumer Evaluations of Brand Extensions" (1990) 54 Journal of Marketing 27–41 [Aaker and Keller].

[5]P. Kotler, and K. Lane Keller, *Marketing Management* 12th ed. (Prentice Hall, 2005) 19.

[6]Aaker and Keller (n 4).

[7]F. Volckner, and H. Sattler, "Drivers of Brand Extension Success" (2006) 70 Journal of Marketing 18–34.

[8]See for example *DC Comics v. Kryptonite Corp.* (2004), 336 F. Supp.2d 324 (S.D.N.Y.); T. Agins, and R. Quick, "Calvin Klein, Warnaco Settle Their Bitter Feud," Wall Street Journal, (21 Jan. 2001) B1.

innovator.[9] The ultimate goal of intellectual property laws is to benefit consumers with product innovations.[10] For this reason, the rights of the innovator are often balanced against the benefits to consumers.[11] In the case of trademark law, under some circumstances, this balance can involve the concept of fair use of trademarked brand identifiers.[12]

In this chapter, we develop a set of tactics aimed at exploiting trademark fair use which we call "Judo Brand Extension" (or JBE) in order to distinguish these tactics from simple imitation which carries far greater legal risk. In fact, many countries provide for the criminal prosecution of trademark counterfeiters in an attempt to deter marketers from the exact copying of famous brands. Close copying of trademarks on similar products is also likely to be condemned as trademark infringement in most countries. The United States further recognises the concept of trademark dilution that condemns the use of a similar trademark on a dissimilar product if the use is likely to diminish the "selling power" of the mark.[13] Most of the court decisions that are examined in this chapter are from the United States.

It is also clear that marketers cannot simply substitute their product for a famous one that has been requested by consumers. For example, Coca-Cola was well-known for policing restaurants that did not serve its brand by using undercover agents posing as customers and ordering a *Coke*. If a customer was served a cola beverage without an accompanying explanation that the restaurant did not serve *Coke*, the restaurant was given a cease and desist letter. Similarly, when the general counsel for *In-N-Out Burgers* ordered a meal at a rival restaurant using names trademarked by *In-N-Out* and received his order without comment, he filed a judicial complaint and successfully obtained a temporary restraining order prohibiting the practice and requiring the rival to inform other consumers placing similar orders that the restaurant did not offer that style of hamburger.[14]

JBE can be described as a form of "judo" business strategy a term made popular by a book by David B. Yoffie and Mary Kwak.[15] In this work, they cite the *Columbia Encyclopedia* definition of judo: "[Judo] depends for success upon the skill of using an opponent's own weight and strength against him, thus enabling a

[9]See D. Shilling, *Essentials of Trademarks and Unfair Competition,* (John Wiley & Sons, 2002) Chap. 1.

[10]Ibid. See also discussion in *New Kids on the Block v. News America Publishing, Inc*. (1992), 971 F.2d 302-8. (9th Cir.) [*New Kids on the Block*].

[11]Ibid.

[12]Ibid.

[13]For further discussion on trademark dilution in the USA generally, please see D. S. Welkowitz, *Trademark Dilution: Federal, State and International Law* (BNA Books, 2002) [Welkowitz]; See also *Trademark Dilution Revision Act of 2006*, Pub. L. No. 109-312, 120 Stat, 1729 (2006) [TDRA].

[14]*In-N-Out Burgers v. Chadders Restaurant* (2007), Case No. 2:07-CV-394 TS, 2007 U.S. Dist. LEXIS 47732 (D. Utah).

[15]D. B. Yoffie, and M. Kwak, *Judo Strategy: Turning Your Competitors' Strength To Your Advantage,* (Harvard Business School Press, 2001).

weak or light individual to overcome a physically superior opponent (p. 1)."[16] Among other things, Yoffie and Kwak argue that judo strategy may leverage an opponent's assets to be used against the opponent. The opponent finds it difficult to respond without diminishing the value of its own assets.[17]

In the case of JBE, a small or new seller introduces a product that imitates or adopts certain aspects of another product's brand identity so as to generate interest in the new product. In order to avoid liability under trademark and unfair competition law, the JBE marketer must be careful not to suggest its new product is actually produced or otherwise licensed, sponsored, affiliated or approved by the well-known brand owner.[18]

JBE marketers free ride, to some degree, on the previous development efforts of the well-known brand owners.[19] When executed carefully, however, the costs associated with any legal challenge are modest, typically in the tens of thousands of dollars, and can be accompanied by spontaneous publicity associated with the legal challenge. Often a small firm can use this publicity to its advantage portraying itself as a small "David" being attacked by a large "Goliath." If the tactic proves effective in attracting consumer interest, then a smaller product introduction budget might be used and/or a better response can be expected from the budget that is used. In addition, the new product may reinforce interest in the well-known brand so that in some cases, this practice may avoid legal challenge altogether. JBE tactics are examined in four categories below: brand resale; compatible products; imitative substitutes; and parody products.

15.2 Four Categories of JBE

15.2.1 Brand Resale

Parties that sell a particular brand of goods are entitled to use the brand name to advertise that fact. For example, an independent dealer of new and used vacuum cleaners can advertise the brands it sells as long as it does not suggest affiliation or endorsement by the brand owners.[20] Similarly, the EU Trade Marks Directive[21]

[16]Ibid.

[17]Ibid 68.

[18]See *New Kids on the Block* (n 10).

[19]See for example, *Merck & Co. Inc. v. Mediplan Health Consulting, Inc.*, 425 F. Supp. 2d 402 (S.D.N.Y. 2006), para. 32, where court held that the purchase of trademarked keywords for search engine placement did not amount to a "use in commerce" because it was an "internal utilization of a trademark in a way that does not communicate it to the public."

[20]*Scott Fetzer Co. v. House of Vacuums, Inc.* (2004), 381 F.3d 477 (5th Cir.).

[21]European Trade Mark Directive, Council Directive 89/104/EEC of 21 December 1988. [EU Trade Mark Directive].

specifically allows non-trademark owners to use the mark to indicate the kind or quality of goods being offered in the course of trade as long as this is done in accordance with honest practices.[22] In *Parfums Christian Dior SA v. Evora*, the European Court of Justice (ECJ) held that even an unauthorised reseller could use the brand name unless the particular situation of use seriously damaged the reputation of the brand.[23]

Similarly, the sale of "re-" goods, for example, those that have been recycled, reconditioned,[24] refurbished,[25] refilled, recharged or repackaged[26] also allows sellers to take advantage of well-known marks. Sellers of "re-"goods are permitted to use the trademark of the brand of the goods provided that they disclose the changed condition of the goods and the identity of the party marketing the goods in that particular form and also disclaim (or at least do not imply) any association or connection with the brand marketer.[27]

One unique form of refurbishing or repackaging is the inclusion of a well-known brand name product as an ingredient in another product. In the United States, this approach is becoming more popular and is typically accomplished by a license or as an arrangement between two brands owned by the same company.[28] However, this can also be performed without permission. Recently, a tuna salad maker was allowed to advertise that it used *Bumble Bee* brand tuna in its salads.[29] In Europe, repackaging and reselling is allowed under the concept of exhaustion of trademark rights after the first sale[30] and serves the important purpose of allowing the free flow of goods within the union.[31] Europe however, imposes the additional requirement that the reseller give prior notice to the trademark owner and, at least in the case of pharmaceutical goods, a specimen of the new packaging so that the trademark owner can ascertain whether the repackaging might damage the trademark as well as to ensure that the repackager is clearly identified.[32]

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[22]Ibid Art. 6.

[23]*Parfums Christian Dior SA v. Evora* BV (1997), Case C-337/95, 1997 EMTR 937.

[24]*Champion Spark Plug Co. v. Sanders* (1947), 331 U.S. 125.

[25]*NitroLeisure Prods. LLC v. Acushnet Co.* (2003), 341 F.3d 1356 (Fed. Cir.).

[26]*Prestonettes, Inc. v. Coty* (1924), 264 U.S. 359.

[27]See generally discussion in C. Schumacher, "Use of Trade-Marks on Repackaged and Relabelled Pharmaceutical Goods" J. Phillips ed., *Trademarks at the Limit,* (Edward Elgar Publishing, 2006).

[28]See discussion in, N. Saqib, and R. V. Manchanda, "Consumers' evaluations of co-branded products: the licensing effect" (2008) 17(2) Journal of Product & Brand Management 73; See also A. Bass, "Licensed extensions – Stretching to communicate" 12(1) 2004, Journal of Brand Management 31.

[29]*Bumble Bee Seafoods, LLC v. UFS Indus.* (2004), 71 U.S.P.Q.2d 1684 (S.D.N.Y).

[30]Under this principle, trademark rights become exhausted throughout the EU territory once a product has been put on the market in any Member State. See EU Trade Mark Directive (n 21) Art. 7(1).

[31]Ibid.

[32]*Hoffman-La Roche* (1978), Case C-102/77, 1978 ECR 1139.

One unusual example of a "product" being resold is the website of Terri Welles, a former *Playmate of the Year*. The Ninth Circuit allowed her to use this trademark and to accurately describe herself as a former *Playmate of the Year* on her website, provided she disclaim any current association with Playboy Enterprises.[33] In essence however, she was reselling her status as a *Playmate of the Year*.

15.2.2 Compatible Products and Services

Not only can resellers advertise the brand they offer, but those who service particular brands of products may advertise that fact as well, again, provided that they do not imply specific affiliation with or authorisation by the brand owner. This practice is permitted under both US and EU law.[34] For example, repair services often sell spare parts. The EU Trade Mark Directive specifically allows sellers of accessories or spare parts to use the trademark of the main product provided such use is in accordance with honest practices.[35] In a case involving razor handles that were compatible with *Gillette Sensor* blade cartridges, the ECJ held that the blade cartridges were the principle products rather than accessories or spare parts. Nonetheless, it held the *Gillette* trademarks could be used if necessary to indicate the intended purpose of the product (as opposed to a generic designation such as, uses all razor cartridges) and if the use was in accordance with honest commercial practices.[36] US law also allows the seller of a compatible or accessory product to use the brand name to advertise the compatibility of the products as long as the advertisement does not imply approval or an association between the two.[37]

Two recent decisions of the ECJ also allow competitors of compatible components to copy most of the product part reference numbers of the primary brand of equipment or parts as comparative advertising to claim their parts are compatible. For example, the Siemens part number, 6ES5-928-3UB21, could be copied by its rival VIPA as VIPA-928-3UB21.[38] Similarly in the USA, *Lean Cuisine* was allowed to truthfully advertise how those following the *Weight Watchers* exchange

[33] *Playboy Enterprises, Inc. v. Welles*" (1998), 7 F. Supp. 2d 1098 (S.D. Ca. 1998), *aff'd mem.,* 162 F.3d 1169 (9th Cir.).

[34] See generally, *Volkswagenwerk A.G. v. Church* (1969), 411 F.2d 350 (9th Cir.) and *Bayerische Motorenwerke AG (BMW) v. Deenik* (1999), ECJ Case C63-97, 1999 ETMR 339.

[35] EU Trade Mark Directive (n 21) Art. 6.

[36] *Gillette Co. v. LA Labs. Ltd. Oy* (2005), ECJ Case C-228/03, 2005 ETMR 67.

[37] See for example, *Polyglycoat Corp. v. Environmental Chems. Co.* (1980), 509 F. Supp. 36 (S.D. N.Y).

[38] See *Siemens AG v. CIPA Gesellschaft fur Visualisierung und Prozessautomatisierrung mbH* (2006), (EJJ 1st Chamber – unreported) (C59/05); and see *Toshiba Europe GmbH v. Katun Germany GmbH* (2002), 3 C.M.L.R. 7 (ECJ 5th Chamber) (C112/99).

points program could use its products, as long as approval by and affiliation with Weight Watchers were clearly disclaimed.[39]

What if a "compatible" product is not functionally compatible, but rather emotionally compatible, such as automobile floor mats that proudly display a particular automobile brand logo? Ornamental use occurs when a trademark is used on a product, not to designate the product's source, but to celebrate the product owner's affection for the brand.[40] To escape liability for counterfeiting, the product used for ornamental purposes such as a T-shirt must not be the primary product offered by the trademark owner. When possible, the product should clearly disclose that it is not authorised or licensed by the brand owner. The logo is not used as a trademark but is simply used nominally to identify a particular brand. For example, the Ford logo appears on all its cars and trucks as a trademark, but when it appears on a T-shirt, hat, or jacket, it is not necessarily being used to identify the source of those products since Ford is not normally thought to be a marketer of clothing.[41]

Early US court decisions tended to allow unlicensed ornamental products particularly when labeling or packaging disclaimed any license or authorisation. For example, a case involving after-market automobile floor mats with unauthorised automobile company logos on them permitted the ornamental use, specifically noting the clear disclaimer on the package and the back of the mats that they were not made by, or authorised by, the automobile company.[42] Such disclaimers can be crucial in determining legality. In a case involving sportswear that mimicked the US National Football League (NFL) colours and stripes but did not use NFL logos, the court enjoined the sale of the clothes unless a disclaimer was included.[43] In a later case, the Eleventh Circuit Court of Appeals enjoined *Battlin' Bulldog Beer* from using a bulldog similar to the University of Georgia mascot (it wore a red sweater with a black "G" and carried a football) on a can that also used the school colours because the disclaimer of sponsorship on the cans was too small to be effective.[44]

In terms of professional sports specifically, while some early court decisions have permitted unlicensed ornamental products, more recent court decisions tend not to allow such products.[45] Although some logo jewellery makers have had some

[39]See *Weight Watchers Int'l, Inc. v. Stouffer Corp*., 744 F. Supp. 1259 (S.D.N.Y. 1990); See also, L. Stansky, "A Brand Everyone Knows" (2003) 25(31) *National Law Journal* A9.

[40]See discussion in Ross D. Petty, "Of Tartans and Trademarks" 9(2004) 4 Trademark Rep. 875–876 [Petty].

[41]*Ford Motor Company. v. Lapertosa* (2000), 126 F. Supp. 2d 463–467. (E.D. Michigan).

[42]*Plasticolor Molded Prods. v. Ford Motor Co.* (1989), 713 F. Supp. 1329, 1335 (C.D. Cal.), *vacated by consent judgment,* 767 F. Supp. 1036 (C.D. Cal. 1991).

[43]*National Football League Properties, Inc. v. Wichita Falls Sportswear* (1982), 532 F. Supp. 651 (W.D. Wash.).

[44]*University of Georgia Athletic Ass'n v. Laite* (1985), 756 F.2d 1535 (11th Cir.).

[45]Compare *Boston Professional Hockey Ass'n, Inc. v. Dallas Cap & Emblem Mfg., Inc,* (1975), 510 F.2d 1004 (5th Cir.), *cert. denied,* 423 U.S. 868 and *University of Pittsburgh v. Champion Prods., Inc*. (1983), 566 F. Supp. 711 (W.D. Pa).

luck defeating the ornamental use defense,[46] professional sports teams have had better luck defeating the defense in recent decisions by using consumer survey evidence to show confusion concerning source or sponsorship of the merchandise. The ECJ has also found that the use of sport team trademarks on ornamental clothing likely jeopardises the guarantee of origin – the essential function of a trademark. Therefore, the trademark owner can prevent such uses even if they are only a badge or demonstration of loyalty, support or affection for the team.[47]

Ornamental use cases in the USA and EU have also condemned unlicensed replica toy cars that use distinctive hood ornaments or grilles of real cars without permission.[48] While the ECJ left open the possibility that consumers might not perceive a toy replica car's use of a trademarked hood ornament as functioning like a trademark to indicate origin (particularly when the toy is marketed under its own trademark), the German Supreme Court on remand found trademark infringement liability.[49]

Another recent US decision also makes it clear that the ornamental use has to be clearly distinguished from a brand extension or accessory. Companion Products Inc. developed a whimsical ornamental product called *StretchPets* that consisted of a stuffed animal head on an elastic body that could stretch around a computer monitor. The original conception of the idea was a black and white spotted cow and was offered as a possible licensed accessory to Gateway, a company that uses black and white cows and cow spots as its trademarks. When Gateway refused to license the product, Companion Products produced it and other animals, but the cow was its best seller since it reminded consumers of the Gateway brand.[50] The court enjoined further sales of the cow Stretch Pet because a survey showed nearly 40% of respondents believed it was made or sponsored by Gateway.[51]

15.2.3 Imitative Substitutes

Although comparative advertising has only recently been permitted in much of Europe, as long ago as 1910 in the USA, notable Justice Oliver Wendell Holmes Jr. acknowledged the acceptability of fair use of another's trademark in comparative advertising: "They have a right to tell the public what they are doing and to get whatever share they can in the popularity of the [trademarked product]. . .by advertising that they are trying to make the same article, and think that they

[46]Petty (n 40) 875.

[47]*Arsenal Football Club plc v. Reed* (2002), ECJ Case C-206/01, 2002 ECR I-10273, 2003 ETMR 19.

[48]*GMC v. Lanard Toys, Inc.* (2007), 468 F.3d 405 (6th Cir.).

[49]*Adam Opel AG v. Autec AG* (2007), ECJ Case C-48-05.

[50]*Gateway Inc. v. Companion Products Inc.* (2004), 384 F.3d 503 (8th Cir.), paras 80 and 85.

[51]See ibid paras 70–71 and fn 8.

succeed."[52] Nearly eighty years later, the Ninth Circuit Court of Appeals explicitly added that comparative advertising is permissible even if the advertiser reaps the benefit of "the product recognition engendered by the owner's popularisation, through expensive advertising, or the mark."[53]

These and other court decisions have opened the door for copycat products. Some such products boldly advertise they are similar to more expensive brands. For example, Parfum de Coeur offers a line of *Designer Imposters* perfumes that it advertises using the slogan: "If you like (a particular brand of designer perfume), you'll love our (imitation brand)."[54] Similarly, a copycat cosmetic firm offers an entire line of generic cosmetics under its trademark, *The Generic Brand*. It used the same bottle shape as Sykes' *Perfect Nail* for its nail hardener and conditioner and labeled it "the Generic Brand tm Version of Sykes' 'Perfect Nail'." The court dismissed the trademark infringement claim asserting there was no likelihood of confusion, but allowed the state dilution claim to proceed to trial.[55] The court held Sykes could win at trial if it could show that the imitator's use of the Sykes' trademarks within its name would likely render the Sykes' trademarks generic.[56]

Store brands typically advertise their similarity to national brands by adopting imitative packaging.[57] To avoid legal liability, they will typically prominently display the store brand name rather than the national brand name. Packaging helps build brand identity both as a form of advertising, particularly at the point of purchase, and as part of brand use experience after purchase.[58] Imitating a well-known brand's packaging could be viewed as a shorthand way of communicating to consumers that the new product is similar to the well-known brand. M. Harvey *et al* report that copycat store brands are an effective way to develop consumer interest and are probably more profitable than non-copycat store brands that need a larger price differential over the national brand to attract as much attention.[59]

In 1992, the US Supreme Court held the imitation of distinctive trade dress to be trademark infringement despite the non-confusing nature of the restaurant names. It noted that the Lanham Act[60] applies with equal force to trademark and trade dress

[52]*Saxlehner v. Wagner* (1910), 216 U.S. 375, 380.

[53]*Anti-Monopoly Inc. v. General Mills Fun Group* 611 F.2d 296, 301. n.2 (9th Cir. 1979); But see *Christian Science Bd. Of Directors of First Church of Christ, Scientist v. Evans*, 520 A.2d 1347, 1355–1356 (N.J. 1987). See also discussion in *Chanel, Inc. v. Smith* (1973), 178 U.S.P.Q. 630 (N.D. Cal.).

[54]See Parfums de Coeur, online: http://www.parfumsdecoeur.com/DesignerImpostersHome.asp.

[55]*Sykes Laboratory, Inc. v. Kalvin* (1985), 610 F. Supp. 849 (C.D. Cal.).

[56]Ibid.

[57]See also *Ty, Inc. v. Perryman,* (2002), 306 F3d 509 (7th Cir.).

[58]R. L. Underwood, "The Communicative Power of Product Packaging: Creating Brand Identity via Lived and Mediated Experience" (2003) 11(1) *Journal of Marketing Theory and Practice* 62–76.

[59]M. Harvey, J. T. Rothe, and L. A. Lucas "The 'Trade Dress' Controversy: A Case of Strategic Cross-Brand Cannibalization" (1998) 6(2) *Journal of Marketing Theory and Practice* 1–15.

[60]Lanham (Trademark) Act codified at 15 USC § 1125(a) (1994).

infringement.[61] At least one US court has disallowed copycat brand packaging, noting that a 1992 Supreme Court decision held that trade dress could be inherently distinctive and therefore protected under trademark law without showing secondary meaning in the minds of consumers.[62] However, most recent US court decisions have allowed this practice as long as the brand name was distinctive. For example, in the 2001 case, *Yankee Candle Company, Inc. v. Bridgewater Candle Company, LLC*, distinctive brand names were held to prevent confusion, despite the similarities of the candles, containers, in store displays, and catalogs.[63] Similarly in *Nora Beverages, Inc. v. the Perrier Group of America, Inc.*, the use of identical bottles for bottled spring water was allowed when distinctive labels and brand names were used (Fig. 15.1),[64] and in *Conopco, Inc. v. May Department Stores Co.*, the court allowed a retailer to copy the trade dress of a national brand as long as the product name was distinctive.[65] Such blatant copying of trade dress is allowed even when done intentionally.[66]

Recently, however, the Third Circuit Court of Appeal took a step backwards from this approach. It held that the use of a prominent well-known store brand name could overwhelm any overall package similarity to avoid consumer confusion, but that the display of a store name anywhere on the package was not an automatic defense to likely confusion. Rather, the Court of Appeal held that courts had to carefully consider the overall impression of the imitative package, including the name, to determine if it was sufficiently similar to cause confusion with a well-known brand. It affirmed the denial of a preliminary injunction for store brands with prominent store names on the package but reversed the denial of a preliminary injunction of the imitative sweetener packaging noted in Fig. 15.2.[67]

While the argument that a distinctive trade name prevents confusion appears to be a viable defense with a number of courts, a JBE marketer might also argue that particular trade dress was merely descriptive and therefore generic to the product category. This defense was successful for Mars when it introduced peanut butter *M&Ms* with colours (tans, orange and brown) and packaging similar to those used by Hershey's *Reese's Pieces*. The court found that such colours and packaging were descriptive of peanut butter candy and not distinctive to *Reese's Pieces*.[68] Such a defense may also work when a brand is slow to challenge the package colour of its

[61] *Two Pesos, Inc. v. Taco Cabana, Inc.* (1992), 505 U.S. 763–773.

[62] *McNeil-PPC v. Guardian Drug Company* (1997), 984 F. Supp 1066–1074. (E.D. Mich.).

[63] *Yankee Candle Company, Inc. v. Bridgewater Candle Company, LLC*, (2001), 259 F.3d 25 (1st Cir.).

[64] *Nora Beverages, Inc. v. The Perrier Group of America, Inc.* (2001), 269 F.3d 114. (2d Cir.).

[65] *Conopco, Inc. v. May Department Stores Company* (1994), 46 F.3d 1556 (Fed. Cir), *rehearing denied,* 1994 U.S. App. LEXIS 34513 (1994), *cert. denied,* 514 U.S. 1078 (1995).

[66] *Bristol-Myers Squibb Company v. McNeil-P.P.C., Inc.* (1994), 973 F.2d 1556–1559 (Fed. Cir.); but see *Philip Morris Inc. v. Star Tobacco Corp.* (1995), 879 F. Supp. 379 (S.D.N.Y.).

[67] *McNeil Nutritionals, LLC v. Heartland Sweeteners LLC* (2007), 511 F.3d 350 (3d Cir.).

[68] *Hershey Foods Corp. v. Mars, Inc.* (1998), 998 F. Supp. 500 (M.D. Pa.).

Fig. 15.1 The packaging in question in *Nora Beverages* and *Conopco*

Fig. 15.2 Imitative sweetener packaging

imitators thereby allowing imitators to pre-empt colour as an identifier of a particular brand. Saccharin-based sweeteners such as *Sweet'n Low* are typically sold in pink packages and aspartame sweeteners such as *Equal* are sold in blue packages.

Copycat products entail legal risks. A court might find either or both the name and packaging to be confusingly similar. For example, Keebler obtained a preliminary injunction when rival Nabisco introduced *Pecan Supremes* with similar trade

dress to Keebler's *Pecan Sandies*.[69] Since both cookies contained pecans, either would be allowed to use "pecan" as part of the brand name. But the court found the brand name *Pecan Supremes* to be confusingly similar to *Pecan Sandies*. In a similar case, the name *basique* was found distinctive from *Clinique* when used with similar packaging in part because many beauty products end with "ique." However, when *basique* was used with the single letter "b" similar to the way Clinique is used with the single letter "C," the court found that use with very similar trade dress to be trademark infringement.[70]

The US Supreme Court recently clarified that only product packaging trade dress (as opposed to product design) can be inherently distinctive.[71] For example, the shape of Pepperidge Farm's goldfish snack crackers can be protected as trade dress because it has nothing to do with the function of cheese crackers. However, because it is the product rather than the package, Pepperidge Farm must be able to prove the shape is a distinctive indicator of the source of the crackers in the minds of consumers. Not surprisingly, it was able to do this.[72] What may be surprising is that in a dilution action against Nabisco for its use of a similar goldfish-shaped cracker, a court granted it product shape trade dress protection over a product that was a mixture of different shaped crackers, including fish. The court found trademark infringement liability even though any possible confusion would occur after purchase, only by non-purchasers, and would likely be temporary because the fish shape was mixed in with other shapes.

Products that are only indirect substitutes may fair better than direct substitutes. Recently the ECJ allowed a beer to call itself *Champagnebier* holding that the EU Comparative Advertising and Trademark Directives[73] and Trademark Regulation[74] must be interpreted permissively and that this comparison did not take unfair advantage of the reputation of *Champagne*.[75]

[69]*Keebler Company v. Nabisco Brands, Inc.* (1992), 1992 U.S. Dist. LEXIS 6826 (N.D. Ill.).

[70]*Clinique Lab. v. Dep Corp.*, 945 F. Supp. 547 (S.D.N.Y. 1996).

[71]*Wal-Mart Stores, Inc. v. Samara Brothers, Inc.* (2000), 529 U.S. 205, 215.

[72]See *Nabisco, Inc. v. PF Brands, Inc.* (1999), 191 F.3d 208 (2d Cir.).

[73]Council Directive 84/450/EEC of 10 September 1984 relating to the approximation of the laws, regulations and administrative provisions of the Member States concerning misleading advertising (OJ 1984 L 250, p. 17), as amended by Directive 97/55/EC of the European Parliament and of the Council of 6 October 1997 (OJ 1997 L 290, p. 18) *and* EU Trade Mark Directive (n 21) respectively.

[74]Council Regulation (EC) No 40/94 of 20 December 1993 on the Community Trade Mark.

[75]*De Landtsheer Emmanuel SA v. Comité Interprofessionnel du Vin de Champagne and Veuve Clicquot Ponsardin SA* (2007) ECJ C-381/05. See also *Haagen-Daz, Inc. v. Frusen Gladje, Ltd.* (1980), 493 F. Supp. 73 (S.D.N.Y.).

15.2.4 Brand Parody Products

Champagnebier might also be considered a parody of *Champagne*. In contrast to other JBE tactics that attempt a serious association with a famous brand, brand parodies attract consumer interest by making fun of a well-known brand. However, parodies can still run the risk of either confusing consumers into thinking they are authorised by the target brand or being accused of trademark dilution.

Parody products are most likely to be considered trademark infringement when the product is the same type as that sold by the trademark owner. For example, a diaper bag marketer was not allowed to use the name *Gucchi Goo* while imitating the trade dress of the *Gucci* brand handbags and totes. The court found that the similarities made it likely that some consumers would think the diaper bag was associated with *Gucci*.[76] The key to successful parodying seems to be in the ability to avoid confusion with sufficient distinctiveness but still have enough imitation so that consumers "get the joke" but aren't confused about sponsorship.

A similar example is Just Did It's parody of *Nike* shirts with its line of *Mike* shirts. The parody shirts offered a "swoosh" design identical to Nike's and the script and style of lettering for *Nike* and *Mike* also were identical. The idea was to poke fun at people who paid money to become a walking billboard for Nike. A federal appellate court reversed summary judgment in favour of Nike finding that it was not a clear matter of law that consumers were confused when making the purchase.[77]

When the parody is obvious and confusion is unlikely, the courts will allow product parodies for the same type of product. A court allowed a maker of designer jeans for larger women to use the trade name *Lardache* as a parody of *Jordache* jeans.[78] The court found that consumers were not likely to be confused that *Jordache* made or sponsored the *Lardache* jeans.[79] It may have helped that the larger jeans arguably were offering social commentary on the limited size offerings of *Jordache*. Similarly, a recent decision allowed a small coffee roaster to continue selling *Charbucks Blend* for a dark roast playing on the consumer perception that *Starbucks* roasts its products more darkly than other brewers.[80] *Charbucks Blend* was sold in distinctive packaging with a different logo so that consumer confusion was found to be unlikely (Fig. 15.3).[81]

When the parody product is distinctively different from the target brand product, it is even more likely the parody will be allowed. For example, a coffee shop and espresso machine seller was allowed to use the name *Federal Espresso* despite the

[76] *Gucci Shops, Inc. v. R.H. Macy & Co.* (1977), 446 F. Supp. 838 (S.D.N.Y.).

[77] *Nike Corp. v. Just Did It Enterprises* (1993), 6 F.3d 1225 (7th Cir.). See also M. S. Lans, "Parody as a Marketing Strategy" (1994) 28(1) *Marketing News*.

[78] *Jordache Enterprises, Inc. v. Hogg Wyld, Ltd.* (1987), 828 F.2d 1482 (10th Cir.).

[79] Ibid 1490.

[80] *Starbucks Corp. v. Wolf Borough Coffee, Inc.* (2007), 477 F.3d 765 (2d Cir.), *case dismissed*, 559 F. Supp. 2d 472 (S.D.N.Y. 2008).

[81] Ibid para 13.

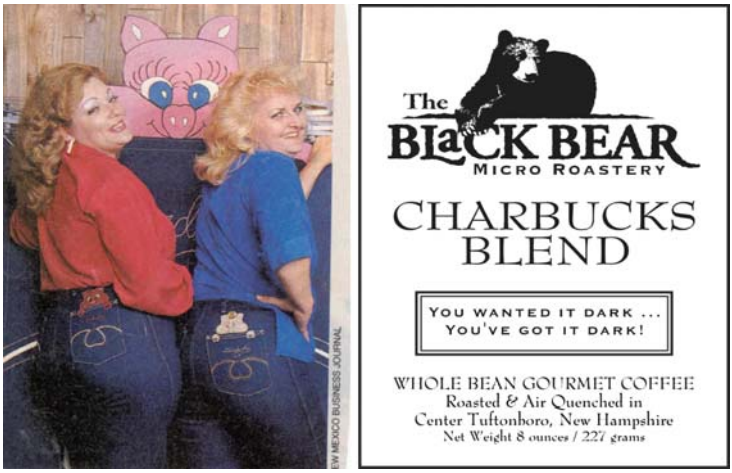

Fig. 15.3 Permitted brand parodies – similar products

objections of the well-known shipping company with a similar name.[82] The name was reportedly selected not so much to parody *Federal Express*, but rather to indicate the original proposed location across from a federal building in Syracuse, New York.[83] Another JBE marketer was allowed to produce T-shirts advertising Myrtle Beach using the slogan "This beach is for you" a parody of the slogan "This Bud's For You."[84] Lastly, a printing company producing pocket calendars and address books was allowed to use the name "Don't Leave Home without Me, Pocket Address Book" despite the similarity to American Express' well-known slogan.[85] These parody examples also include common and descriptive words that courts are reluctant to let brand owners monopolise through trademark law.[86]

Offensive or tasteless parody products may be further condemned for trademark tarnishment.[87] Unlike the address book example above, when a condom maker decided to package its product in a card that precisely duplicated the well-known American Express credit card and the condom package inside the card stated "Never Leave Home Without It" imitating American Express' well-known slogan,

[82]*Federal Express Corp. v. Federal Espresso Inc.* (2000), 201 F.3d 168 (2d. Cir.).

[83]Ibid paras 4 and 5.

[84]*Anheuser-Busch, Inc v. L &L Wings, Inc.,* (1992), 962 F.2d 316 (4th Cir.), *cert. denied,* 506 U.S. 872.

[85]*American Express Co v. CFK, Inc.* (1996), 947 F. Supp. 310 (S.D. Mich.).

[86]See for example, *WCVB-TV v. Boston Athletic Association* (1991), 926 F. 2d 42 (1st Cir.) paras 9–11; See also *Wonder Labs, Inc. v. Proctor & Gamble Co.* (1990), 728 F. Supp. 1058 (S.D.N.Y.).

[87]Trademark tarnishment is a form of dilution where the non-owner uses the mark in connection with obscene or illegal activities or other negative associations. See for example discussion in Welkowitz (n 13) 159–162.

Fig. 15.4 Permitted brand parodies – no tarnishment

the court found dilution by tarnishing.[88] The court also however found no infringement since consumers would not think American Express endorsed the practice.[89] Similarly, a court enjoined a company from producing a *Buttwiser* T-shirt because it would tarnish the *Budweiser* trademark.[90]

Most recently however, the Fourth Circuit Court of Appeals allowed a parody dog toy called *Chewy Vuiton* despite the protests of handbag marketer *Louis Vuitton*.[91] The court found this to be a valid parody because it conveyed just enough of the original trademark to be recognised by consumers, it communicated an element of satire or amusement and it was sufficiently different to communicate it was not the original product.[92] In one of the first appellate decisions interpreting the Trademark Dilution Revision Act of 2006,[93] the court also found no dilution by blurring because strong famous marks are less likely to have their distinctiveness impaired by a parody.[94] The differences between the parody and original also help preserve the distinctiveness of the original. Lastly, the court also affirmed dismissal of the argument that this parody might tarnish the original trademark because a dog might choke on the chew toy (Fig. 15.4).[95]

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[88]*American Express Company. v. Vibra Approved Laboratories Corporation* (1989), 10 U.S.P.Q. 2d 2006. (S.D.N.Y.) 2012–2013.

[89]Ibid paras 20 and 21.

[90]*Anheuser-Busch, Inc. v. Andy's Sportswear, Inc.* (1996), 40 U.S.P.Q.2d 1542 (N.D. Cal.), 1543. (N.D. Cal. 1996).

[91]*Louis Vuitton Malletier, S.A. v. Haute Diggity Dog, LLC* (2007), 507 F.3d 252 (4th Cir.) [Louis Vuitton].

[92]Ibid para 32.

[93]TDRA (n 13).

[94]Louis Vuitton (n 91), para 34.

[95]Ibid paras 36 and 37; See also, *World Wrestling Federation. Entertainment, Inc. v. Big Dog Holdings, Inc.* (2003), 280 F. Supp. 2d 413 (W.D. Pa.) and *Tommy Hilfiger Licensing, Inc. v.*

15.3 Conclusion

Successful brands are the envy of other marketers. Associating with a successful brand can boost interest and sales in a new product, but the law is clear that the association must not falsely suggest the same origin as the famous brand or its sponsorship, affiliation, or approval. In other words, in order to avoid liability, the JBE marketer must not suggest its product is actually a brand extension authorised by the famous brand and should not use the famous brand's trademark as its own trademark. Indeed, the JBE marketer should always be clear that its product comes from a different source than the well-known brand. The well-known brand's trademarks should be used indirectly such as in advertising comparing the well-known brand with the JBE marketer's brand rather than directly as a trademark for the unauthorised extension. A second step that helps reduce liability is for the JBE marketer to use a modified version of the famous trademark in a way that is noticeable to consumers. Consumers who notice the differences in the trademarks are less likely to be confused into thinking that they are from the same source. Parody brand extensions are a good example of modified trademarks that are noticeable to consumers. Finally, the JBE marketer should consider targeting a famous brand in a completely different industry if possible. Although beer and wine are both alcoholic beverages, wine consumers are not likely to think that *Champagnebier* actually comes from the Champagne region of France or is produced by champagne companies.

The law appears to generally allow resellers and makers of compatible products to make associations with the related famous brand. The one exception to this that has recently appeared is related to ornamental products. US sports teams and others have been successful in using consumer survey evidence to show consumers believe sports merchandise must be authorised by the brand owner. However, there are still some other product types such as automobile floor mats or keychains and fraternal logo jewellery where a license is not required. Substitute products also carry significant risk of legal liability and JBE marketers must be careful not to suggest affiliation with the famous brand. Parody products, in contrast, appear to have a lower legal risk because brand owners are not likely to sponsor or license a parody of their own brand.

While the implementation of a JBE strategy may result in a "cease and desist" letter from the relevant trademark owner, the JBE marketer can respond by arguing that the association is either accurately depicted (and therefore legally allowed) or does not suggest authorisation by the well-known brand. The JBE marketer may also have to defend against a preliminary injunction, but such cases are often both

Nature Labs. LLC (2002), 221 F. Supp. 2d 410 (S.D.N.Y.), where lower courts allowed pet-related parody T-shirts (*Bone Cold Steve Pawstin*) and perfumes (*Timmy Holedigger*) respectively; For further discussion on balancing trademark protection with parodists' free speech claims see, R. J. Shaughnessy, "Trademark Parody: A Fair Use and First Amendment Analysis" (1986) 72(Sept.) *Virginia Law Review* 1079–1117.

quick and decisive for the overall dispute. In some cases, compromise modifications of the product appearance may be negotiated to avoid larger legal expenses. In any event, it should be expected that a JBE strategy will incur some legal costs, particularly for substitute products. That being said, there are clearly benefits to be gained from JBE. These might include benefits that arise from public sympathy and support for a David vs. Goliath story where the small new brand is being sued by a large bullying brand. Indeed, public relations sympathy can create additional interest in the brand that might carry over even if the JBE brand must ultimately be modified in some way. On balance however, a marketer should only ever engage in JBE if it believes the benefits to product introduction will outweigh what are clearly foreseeable legal costs.

Chapter 16
The Effect of Complexity of Law on Litigation Strategy

Diarmuid Rossa Phelan

Abstract This chapter proposes that complexity of the law inspires litigation strategies. The chapter illustrates through reference to different areas and jurisdictions, but does not prove, the central contention that the legal system has become so complex that the rule of law has been damaged to the point where the system has become detached from the subjects it is meant to serve. The chapter points to the absence of a remedy by the legal system itself against these systemic flaws and consequently the legal strategies exploiting them, and propounds that litigation strategy is distinct from strategy merely embraced in litigation.

The paper is a reflection on the complexity of law and presents some general examples of intra-systemic failures of the litigation process, with particular focus on those caused by delay. The paper proposes that the legal system fails both in concept and in practice in that the system is incapable of administering its own complexity and provides no remedy against itself.

16.1 Introduction

This chapter considers the effect of complexity of law (along with its attendants, time and cost) on the planning of contests of justiciable issues – law or fact – through the court process. The chapter aspires to focus on the legal and litigation variant of strategy, which arises from the nature of law revealed through the litigation process. To clarify this with two distinctions: First, there is a distinction between litigation strategy and a more general strategy of which litigation is an element. For example the goal of a litigant may be to pressure or distract the

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other party in order to advance its plans for something else entirely, in which case litigation or litigation strategy becomes a tactic in an overall strategy. Second, there is a distinction between strategy linked to litigation and the employment of specific strategies within litigation such as psychological, economic, public-relations strategies and political influences, etc. The systematic employment of psychological or economic tactics in litigation may very well be termed "litigation strategy". While this contribution does not take issue with such labeling, it focuses on the strategies that arise out of the nature of litigation and also reflects upon the nature of the law, as revealed by those strategies.

I contend that the defining feature of much, but not all of, present litigation is complexity, that complexity increases delays and in turn, cost. Delay and cost are now such overpowering constituents of the experience of litigation that any litigation planning must take full cognizance of them in order to know whether to deploy or avoid. The chapter is a reflection on this complexity of law effect. It presents some general examples of intra-systemic failures of the litigation process, in particular those caused by delay. It proposes that the litigation system fails both in concept and in practice, in that the system is incapable of administering its own complexity and provides no remedy against itself. The chapter spotlights the "unthought", the disavowed presuppositions and the consequences of a generally accepted and unchallenged structure.[1] In the light of the international scope of the editors' project in this book, examples are drawn from a variety of jurisdictions and areas of the law.

Two particular points are made regarding the analysis of the health of the legal system hereunder. First, law has become so complex in structure, language, extent and sources, that it does not provide systematic guidance for conduct. Further, law exists in time and its processes are lengthy. Thus, in its identification and application, law is far more random than its concept allows, particularly over time. Second, legal systems do not practice or deliver what they profess. That is, the standards of behaviour set out and enforced by the legal system tend not to be conformed to by the operation of the legal system itself. While complexity and delay are in need of evidence and substantiation, this paper largely assumes that the reader's experience in the law confirms complexity and delay, and consequently limits proof by reference to specific examples only.[2]

[1] A definition and approach advocated by Slavoj Zizek. For comprehensive discussion see S. Zizek, *The Parallax View* (MIT Press, 2006).

[2] For additional discussion on strategic opportunities that arise out of the difference between what legal norms should be and what they are in practice due to for example, "hazy law" and "crazy law", see A. Masson, "The Origin of Legal Opportunities" (2009), Chap. 3 of this text [Masson].

16.2 Complexity

16.2.1 Complexity in General

As noted above, the law is extremely complex in substance and therefore uncertain in its application. These characteristics of law can overpower the effect of law to such an extent, that the law is ultimately not that which was originally intended, or, if it is, then in theory only. Upon reflection, most readers of this chapter will be able to think of many examples of the complexity of law to the point of opacity. Often in consultations, barristers will attempt to cut through the morass and indeed their own doubt, by referring to what a judge is most likely to do. Indeed, the role of the two layers of professionals – barristers and solicitors[3] – plus the judge often rests on the tacit assumption that the law is unclear and may remain so. Thus, a senior barrister will make an estimation of the judge's likely reactions, since a judge is likely to be close in training, outlook and experience to himself.[4] Further, a solicitor will consult the barrister since, at a minimum, two minds are likely to be better than one. This observation is not a comment on the competence of legal professionals but rather is an observation on the day to day practically workings of the legal system which, as a whole, tends to incorporate legal realist prediction.

16.2.2 Complexity in Source

Legal sources of law typically include many levels of statutory or legislative enactments and case-law. Thus, using Ireland as an example, this could include: the Constitution; the statutes of the Oireachtas; statutory instruments; bye-laws[5] of County Councils; case-law; decisions of administrators; and decisions of enforcement authorities.[6] Further, there are the constituent treaties of the European Union (EU) and Communities; the treaties concluded by the EU and Communities; European Parliament, Council regulations and directives; implementing Commission regulations; and implementing Member State measures which can include constitutional or statutory instruments, and administrative circulars or decisions. There may also be Member State exemptions; decisions of the Commission; guides to interpretation and practice in Commission Notices; and case-law. Finally, it must

[3]The division of the profession into barristers and solicitors continues to be practiced in a number of jurisdictions. For further critique on the need for such a distinction in the UK see J. R. Spencer Jackson's Machinery of Justice, 8th ed. (Cambridge University Press, 1989) 353.

[4]For further discussion on the impact of the shared background between lawyers and judges on judgments see, B. Barton, "Judges, Lawyers and a Predictive Theory of Legal Complexity" (2008) University of Tennessee Legal Studies Research Paper No. 31 [Barton].

[5]Also seen as "by-law" or "bylaw".

[6]Other Member States of the EU would have variants of the sources of law as listed.

also be noted that there may be default in implementation and further noted that these constitutional orders interact in source, scope, and range.

For example, a treaty concluded by the EU with a third country, multi-laterally or with an international organization with legal personality, might require a regulation of the European Parliament and Council on a proposal by the Commission. The competence to enter into the treaty will have been determined by: the European constituent treaties; public international law (customary and treaty based in the Vienna Convention on the Law of Treaties); and case-law from the Court of Justice of the European Communities. If the competence is in doubt, measures adopted pursuant to an incompetently adopted treaty can be challenged. The new regulation may require further implementation by Commission regulation. The regulations may amend existing directives. The directives may have required implementation in a Member State. The Member State may have had legislation covering a range of matters in place on foot of a constitutional obligation. Various acts of Parliament might have various provisions contrary to the directive once implemented. The Member State may have implemented the directive by statutory instrument, within or without the time period allowed by the directive, amending the pieces of legislation in applicable part, and possibly taking precedence even over subsequent legislation, depending on the interpretation of the Act under which the statutory instrument is made. The pieces of legislation may themselves have been amended or replaced in part by subsequent legislation. The name of the statutory instrument may bear no relation to the name of some or all of the pieces of legislation. The directive may only require amendment of the law in respect of intra-Community matters and thus be limited jurisdictionally in this sense or in respect of Community citizens. Consequently, the pieces of legislation amended in part by the statutory instrument might have been amended only in respect of certain transactions covered in its scope or for certain persons engaged in certain transactions. The existing directive may now be amended by the regulation implementing the treaty or the Commission's implementing regulations. Additionally, there may be a case pending on the interpretation of the power to conclude the treaty. Further, any number of other mechanisms at different levels and at different speeds may be in operation.

In addition to the foregoing, a particular action or transaction of an entity, personal or corporate or government, will often have many different aspects to it as well as many different laws that might be applicable. The activity is often also not punctual but has duration over time and the law may change over that period of time. This however only considers the single transaction of one entity. Clearly, such a transaction will operate and be, in part, constituted by a mass of other rules, themselves in the same system and in flux.

16.2.3 Complexity in Quantity

The sheer volume of law produced is massive. No one person can read it all, let alone know it. That being said, at one time in Iceland, there was a limit of the

extent of its legal system. During the annual gathering of the Althingi (national parliament), at the Logrétta (Law Council) the Lögsögumaður (law speaker) would recite the laws from memory. He could also be challenged by the Assembly.[7] Again, using Ireland as an example, a similar task would require reading all of the European Community (EC) secondary legislation; national statutes; statutory instruments and bye-laws; reported decisions of courts; and authorities. Even if such a feat could be achieved, it is doubtful that the lawyer would be able to understand the law without reading and memorising the gist of the preceding law. Such activities appear entirely unproductive, save for its dim resonation to the law's gongs of promulgation.

The volume of law is such that journalists frequently refer to it in simple quantitative terms. For example, regarding the European Union, in an article from the *Financial Times* entitled "Standard Bearer – How the European Union Exports Its Laws", the author refers to the extent of EU law as "a body of law running to almost 95,000 pages".[8] Nothing however appears to compare to the quantity of laws promulgated in the United States. For example, Bill Clinton was recently reported as holding the record for "Midnight Hour" regulations, issuing 26,000 pages worth of Federal rules in the last three months of his presidency alone.[9]

16.2.4 Complexity in Promulgation

In Ireland, there is no consolidation of laws of any extent nor is there any single point of publication. For Member States generally, the interaction of the various sources of law makes publication diffuse and defeats consolidation, even in civil law countries. EC law is not consolidated. Technically however, the material is available somewhere and a web-adept lawyer may indeed be able to track it all down keeping in mind that web law is often non-authoritative and unreliable.

16.2.5 Complexity in Enforcement

A big imponderable is whether the law will be enforced at all. Given the sheer volume of regulatory law, institutions and activities along with extensive ignorance

[7]For further discussion of the historical background to the Icelandic parliament see R. Cleasby, G. Vigfússon, and A. Craigie, *An Icelandic-English Dictionary*, 2nd ed. (Clarendon Press, 1957) 405.

[8]T. Buck, "Standard Bearer – How the European Union Exports its Laws", *The Financial Times*, (10 July 2007) 13.

[9]See E. Kolbert, "Comment – Midnight Hour", The New Yorker, (24 November 2008) 39, online: http://www.newyorker.com/talk/comment/2008/11/24/081124taco_talk_kolbert.

of the current law in force, individuals or entities sometimes take the view that they will proceed until an enforcement authority pursues them and will comply only when the law is clearly demonstrated.[10]

The identity of the enforcer can also be complex. For example, in Irish competition law, enforcement may be pursued by a number of entities including: the European Commission; the Irish Competition Authority; the Communications Regulator; the Director of Public Prosecutions; or a private litigant.

Further, the influence of underlying policy can also make enforcement inconsistent and difficult to predict. For example, insurance company approvals, demonstrate that it is often the making of the claim, i.e. the claim process, and not the correctness or incorrectness of the substance of the claim, which can be of greater importance. In the case, *Johnson* v. *Medical Defence Union*,[11] Rimer J. held that Medical Defence Union's risk assessment policy was not unfair despite measuring risk based on a doctor's personal compatibility with patients as opposed to clinical competence. "A complaint, when made, may well be unfounded, but may also be expensive to defend".[12]

Similarly, under- and/or over-enthusiastic enforcement, adds to its complexity. In a *New Yorker* article about the effect of police intervention on marijuana dispensaries, despite their legalisation by state law, the writer describes how repeated police raids and confiscations can shut down the dispensaries in fact, despite the outcome of ensuing legal challenges to the police behaviour:

> Although the police behavior he described may seem excessive, it is usually forgiven by judges who try to balance the competing demands of state and federal law. By routinely looking the other way when law-enforcement officers make 'mistakes,' the courts have allowed police officers that don't like current state law to work around it, and put pressure on people . . . .[13]

The notion of questionable enforcement is not new. P. Charleton in "Lies in a Mirror: an Essay on Evil and Deceit" described the Inquisition as follows:

> . . . the methods ordinarily allowed, which supposedly did not imperil the life or limb of the captives, included prolonged solitary confinement in unhealthy conditions, starvation, the use of prisoners posing as confidants in heresy and the deliberate delay of proceedings to keep alive a state of unbearable panic at not knowing one's fate.[14]

[10]For discussion on "flexible law" see Masson (n 2) 2.2.4.

[11]*Johnson v. The Medical Defence Union Ltd.* (2) [2006] EWHC 321 (Ch) (03 March 2006).

[12]Ibid para. 123.

[13]D. Samuels, "Dr. Kush. How Medical Marijuana is Transforming the Pot Industry", The New Yorker, (28 July 2008) 49, online: The New Yorker http://www.newyorker.com/reporting/2008/07/28/080728fa_fact_samuels?currentPage=all.

[14]P. Charleton in "Lies in a Mirror: an Essay on Evil and Deceit" (2006 Blackhall Publishing) 48–49.

16.2.6 Complexity in Language

Law is impenetrable not only because of its volume or the way in which it is enacted[15] but also because of the complexity of the language itself which is further exacerbated by judicial interpretation.[16] Furthermore, some areas of law leave huge scope for the influence of practitioners such that the outcome is not discernible to the outsider.

16.2.7 Complexity in Litigation

The legal procedures for determining rights and liabilities are complex. Indeed, litigation can cause injustice by time, expense and in determination of facts. The courts face numerous challenges in getting to the bottom of both legal and factual matters. The courts must rely on law and evidence that has been filtered through potentially more than one layer of professional and exacerbated by epistemic memory problems worsened by time and often encouraged by adversarial presentation.

The legal system and procedure is designed by lawyers and potentially involves multiple layers of presenting professionals. While judges are typically polite, a lay litigant is often lost. The professionalisation of access to justice is non-instinctual. If one was to start from the premise that the system ought to be such that the norm is lay litigants, it would arguably be completely different – in terms of complexity and procedure. The profession of lawyer is often perceived as a profession which facilitates complexity, rather than a profession which evolved to answer injustice.[17] This standard viewpoint is not necessarily founded on costs associated with the profession but rather on the realisation that the legal system is one which can only be run by professionals. In fact, it appears to me that complexity has even outstripped that position. Indeed, complexity is now held in check only by the inability of judges and lawyers to understand, or litigants to fund investigation into what is the law. This has not resulted in a simpler system but rather a system fraught with error. Here, other factors, not the law, become important and the Rule of Law is lost.

[15]See above Sect. 16.2.2, "Complexity in Source".

[16]As an example, take the following sentence from a judgment of the European Court of Human Rights: "The fact that the permits fell within the ambit neither of the second sentence of the first paragraph nor of the second paragraph does not mean that the interference with the said right violated the rule contained in the first sentence of the first paragraph". *Sporrong v. Sweden* (1983) 5 EHRR 35 (ECHR) 69.

[17]See for example, Barton (n 4); See also discussion in P. Nayler, *Business Law in the Global Marketplace* (Butterworth-Heinemann, 2005) 3.

16.2.8 Hypocrisy in the Substance of the Law

Ignorantia juris neminem excusat. Ignorance of the law is no excuse. Although this is a maxim, it can operate as a substantive principle to deny a person intending to abide by the law the defence that he did not know what the law was. Behind this maxim may be a logic that the subject of the law ought to identify the law. Yet often, not even lawyers know what the law is.[18]

16.2.9 Hypocrisy in the Structure of the Law

The removal by the law of the defence of ignorance of the law is a *sine qua non* of a complex modern legal system. Law's most basic claim is that it provides a guide to conduct. Where no one can know what the law is, this most fundamental claim is hypocritical.

16.2.10 Complexity in Time

The time taken to have a matter disposed of before Courts is often too long. For most matters, it can be years from the origin of a dispute to its authoritative determination.[19] Exacerbating delay is that legal processes seem to have a limited ability to inquire into themselves. For example:

In Ireland, while Courts review the administrative decisions of bodies for breaches of natural and constitutional justice, including delay, they do not consider the delay before themselves. A further example in Ireland is the failing of its Tribunals of Inquiry. While Tribunals of Inquiry can be established to investigate matters of public importance, including failures in systems, they have been harshly

[18]See discussion by Lynn LoPucki concerning what he describes as the law in lawyers' heads: "Law exists in the minds of lawyers in a form separate and critically different from its form on the books" in L. M. LoPucki, "Legal Culture, Legal Strategy, and the Law in Lawyers' Heads" (1996) 90 Nw. U. L. Rev. 1527 and in L. M. LoPucki, and W. O. Weyrauch, "A Theory of Legal Strategy" 2000 49(6) Duke Law Journal 1405, an edited reprint in this text at Chap. 4; See also discussion on "hazy law" in Masson (n 2) 2.2.2.

[19]For detailed administrative statistical breakdowns, please see Court Services of Ireland online: Courts Service of Ireland http://www.courts.ie; The wrong of delay has been addressed in principle since at least the thirteenth century. In Chapter 40 of The Magna Carta, John, King of England, Lord of Ireland, Duke of Normandy and Aquitaine, and Count of Anjou, on 15 June 1215 at Runnymede agreed: "To none will we sell, to none deny or *delay* right or justice". (Emphasis added). The phrase "justice delayed is justice denied" embraces only a single element of this. It is commonly attributed to Gladstone, but William Penn used it in 1693 ("to delay justice is injustice"). The Magna Carta addresses the two elements of time and money, but money only in so far as it is direct payment to the decision maker.

criticised for their ineffectiveness, expense and slowness, with the inquiry often dragging on for more than a decade.[20]

In Italy, the strategic employment of the delays in its legal system is referred to simply as "launching the Italian torpedo".[21]

The Court of Justice of the European Communities, which requires that remedies for breaches of Community law be effective, takes approximately 20 months to make a preliminary ruling under Article 234 EC Treaty[22] to clarify the law before the national court. This period will be on top of whatever time the national courts need.

The European Court of Human Rights (ECHR) under the European Convention on Human Rights protects *inter alia* the right to a speedy trial[23] and the right for anyone arrested or detained to be promptly brought before a judge.[24] Yet at the end of 2006, there were 89,887 applications pending before the Court and of these, 23,000 cases had not been assigned to the appropriate judicial formation.[25] The procedure in the ECHR is slow despite its own jurisprudence regarding the speed of decisions. Delay is of increased significance since the ECHR is the final port of call

[20]See for example, Office of the Comptroller and Auditor General, Special Report 63: Tribunals of Inquiry Summary, online: Special Report 63 http://www.audgen.gov.ie/viewdoc.asp?DocID=1134.

[21]Assistant Legal Adviser Jeffrey Kovar, speech to US Chamber of Commerce, on forum-shopping (25 March 2004) explains the concept as "In Europe, as I understand it, it is known as launching the 'Italian Torpedo' to rush into Italian court and file a declaratory judgment action of no liability when you fear you are about to be subject to suit. Because Europe has a strict first-in-time *lis pendens* rule for dealing with parallel lawsuits, the action will not be permitted to go forward elsewhere. The company that fires the 'torpedo' can then expect that the case will be tied up so long in the Italian courts that it is effectively shielded indefinitely from liability". Online: 54. Assistant Legal Adviser http://www.state.gov/s/l/2004/78290.htm.

[22]The Consolidated Version of the Treaty Establishing the European Community, EN 24.12.2002 Official Journal of the European Communities C 325/5, Article 234: "The Court of Justice shall have jurisdiction to give preliminary rulings concerning: (a) the interpretation of this Treaty; (b) the validity and interpretation of acts of the institutions of the Community and of the ECB; (c) the interpretation of the statutes of bodies established by an act of the Council, where those statutes so provide.Where such a question is raised before any court or tribunal of a Member State, that court or tribunal may, if it considers that a decision on the question is necessary to enable it to give judgment, request the Court of Justice to give a ruling thereon".Where any such question is raised in a case pending before a court or tribunal of a Member State against whose decisions there is no judicial remedy under national law, that court or tribunal shall bring the matter before the Court of Justice.

[23]Convention for the Protection of Human Rights and Fundamental Freedoms as amended by Protocol No. 11 with Protocol Nos. 1, 4, 6, 7, 12 and 13, [European Convention on Human Rights] Art. 6(1).

[24]Ibid Arts. 5(3) and 5(4).

[25]Council of Europe, European Court of Human Rights, *Survey of Activities* (2006) 3, online: echr.coe.int http://www.echr.coe.int/NR/rdonlyres/69564084-9825-430B-9150-A9137DD22737/0/SurveyofActivities2006.pdf.

to air a grievance[26] and the system appears to provide no remedy against itself. For example:

- *Tunç v. Turkey*, Record no. 54040/00: failure by authorities to pay sums awarded by final court judgment – 5 years from date of application to date of decision.
- *FILIP v. Romania*, Record no. 41124/02: absence of speedy review of a psychiatric committal – 4 years from date of application to date of decision.
- *Scordino v. Italy (No.1) & 8 Other Cases*, Record no. 36813/97: Article 6(1) – 9 years from date of application to date of decision resulting in delay in the payment of compensatory awards following compulsory purchase of land.[27]
- *Pantea v. Romania,* Record no. 33343/96: Article 5(3) and failure to bring promptly before a judge. Violation was found – 7 years 10 months from date of application to date of decision.
- *Sen v. Turkey*, Record no. 41478/98A: failure to bring promptly before a judge in a region subject to a state of emergency and relating to Article 5(3) took – 7 years 2 months from date of application to the date of decision.
- *O'Hara v. UK*, Record no. 37555/97: Article 5(3) and failure to bring promptly before a judge – 4 years and 5 months from date of application to date of decision.
- *Rutten v. Netherlands*, Record no. 32605/96: Article 5(4) and speed of review of continuing detention – 5 years 2 months from the date of application to the date of decision.
- *Ilowiecki v. Poland*, Record no. 27504/95: Article 5(4) and length of time taken to decide on requests for release – 6 years 11 months from date of application to date of decision.
- *Vodenicarov v. Slovakia*, Record no. 24530/94: Article 5(4) and absence of a speedy review of psychiatric detention – 7 years 2 months from date of application to date of decision.
- *Baranowski v. Poland*, Record no. 28358/95: Article 5(4) and length of time taken to decide on requests for release – 5 years 10 months from date of application to date of decision.
- One judgment delivered in 2004 concerned numerous cases involving the delay in compliance with court decisions by national authorities. The number of cases alone suggests that this type of delay is common.[28]

[26]European Convention on Human Rights (n 23), Article 26 provides that "the Commission may only deal with the matter after all domestic remedies have been exhausted, according to the generally recognised rules of international law, and within a period of six months from the date on which the final decision was taken".

[27]Note: The original Italian case dates back to 1989. The case was originally lodged with the Commission and was transferred to the Court in 1998 so perhaps a figure of 7 years is a fairer estimate of the delay before that Court.

[28]The cases were as follows: *Sabin Popescu v. Romania*, no. 48102/99; *Croitoru v. Romania*, no. 54400/00; *Prodan v. Moldova*, no. 49806/99; *Sîrbu and others v. Moldova*, nos. 73562/01, 73565/01, 73712/01, 73744/01, 73972/01 and 73973/01; *Luntre and others v. Moldova*, nos. 2916/02, 21960/02, 21951/02, 21941/02, 21933/02, 20491/02, 2676/02, 23594/02, 21956/02, 21953/02,

Complexity causes delay. In so far as delay results from insufficient Court resources, in my experience, it has never been put to a Court that the Court has an obligation to deal with backed-up lists of cases by requiring the executive organ of Government to provide more judicial resources, or by requiring the legislative organ of Government to simplify, or by requiring themselves to sit without break until the lists are cleared. There are good, if not sufficient reasons for this. The judge sitting on the bench in the particular constituted court in which the problem arises is not responsible for the build-up within the courts system, or for the complexity of the law, or for the insufficiency of resources to deal with the level of complexity. The issue of the delay within the courts system itself in processing the claim will not be part of the statement of the claim before the court, but an incident of its processing. Consequently, in many ways, the issue is not properly framed and given its sensitivity, the raising of the issue directly before the court seeking expedition could easily appear as an inappropriate personal admonition or even an irrelevant harangue. Yet silence on the issue of cost and delay has tremendous negative impact on the litigants stuck in the courts.[29]

However, the issue of a constitutional provision being relied upon to require the State to better fund the Courts has been raised in the United States, at least in the abstract. Per Daniel W. Halston:

> Even though most of the Massachusetts decisions discussing the open courts clause suggest it primarily guarantees a right to a remedy and acts as a constraint on the judiciary, there is ample evidence that the clause, once placed in historical context, was actually intended to create and protect an independent judiciary. When the clause was drafted, colonial America was eager to insulate the courts from interference by the English Crown. Article 11, and the founding fathers' concern for an independent judiciary, could well serve today to protect the courts from challenges to their independence arising from the debate over the allocation of scarce state resources. It could also serve as a source of authority for litigants who may challenge the current allocation of resources to the judicial branch on the grounds that it results in justice denied or unconstitutionally delayed. Such claims may ultimately produce a more thorough understanding of Article 11.[30]

21943/02, 21947/02 and 21945/02; *Pasteli and others v. Moldova*, nos. 9898/02, 9863/02, 6255/02 and 10425/02; *Bocancea and others v. Moldova*, nos. 18872/02, 20490/02, 18745/02, 6241/02, 6236/02, 21937/02, 18842/02, 18880/02 and 18875/02; *Croitoru v. Moldova*, no. 18882/02; *Ţîmbal v. Moldova*, no. 22970/02; *Shmalko v. Ukraine*, no. 60750/00; *Zhovner v. Ukraine*, no. 56848/00; *Piven v. Ukraine*, no. 56849/00; *Voytenko v. Ukraine*, no. 18966/02; *Romashov v. Ukraine*, no. 67534/01; *Bakalov v. Ukraine*, no. 14201/02; *Bakay and others v. Ukraine,* no. 67647/01; *Mykhaylenky v. Ukraine*, nos. 35091/02, 35196/02, 35201/02, 35204/02, 35945/02, 35949/02, 35953/02, 36800/02, 38296/02 and 42814/02; *Derkach and Palek v. Ukraine*, nos. 34297/02 and 39574/02; *Metaxas v. Greece*, no. 8415/02; *Zazanis and others v. Greece*, no. 68138/01; *Mancheva v. Bulgaria*, no. 39609/98; *Wasserman v. Russia*, no. 15021/02; and *Qufaj Co.Sh.P.K. v. Albania*, no. 54268/00.

[29]See also discussion by Ministry of the Attorney General, Ontario Civil Justice Review, First Report (March 1995) Chapter 12, "Backlog", online: Ministry of the Attorney General http://www.attorneygeneral.jus.gov.on.ca/english/about/pubs/cjr/firstreport/default.asp.

[30]D. W. Halston, "The Meaning of the Massachusetts 'Open Courts' Clause and its Relevance to the Current Court Crisis" (2004) Vol. 88 n. 3 Massachusetts Law Review.

Article 11 of the Constitution of the Commonwealth of Massachusetts provided:

> Every subject of the commonwealth ought to find a certain remedy, by having recourse to the laws, for all injuries or wrongs which he may receive in his person, property, or character. He ought to obtain right and justice freely, and without being obliged to purchase it; completely, and without any denial; promptly, and without delay; conformably to the laws.[31]

The independence of the judiciary is one of a number of guarantees which could be prayed in aid of advancing an argument that under-resourcing of the administration of justice in the courts is an area of exception to the general rule that the courts will not compel the executive or legislative or organs of government to expend monies.

16.2.11 Exceptions

There are examples of how the legal system, while professing to be complete, moves somewhat disparately and without program to provide exceptions for the problems caused by complexity and limited resources. While the evolution of such exceptions may strike the reader as being somewhat "common law" in style, they are not confined to common law jurisdictions.

For example, some systems of enforcement depend on the non-enforcement of breaches of the law which are deemed to be *de minimis*. Take as an example the European Commission's enforcement of Competition Law. While not strictly expressed by the law, the Commission in practice does not deal with *de minimis* matters and has a quantitative cut-off.[32]

When determining the admissibility of evidence, the court can take into consideration, issues related to the length of a trial. The test of relevance was succinctly set out in the 1991 New Zealand case of *R v. Wilson*[33] as follows:

> Lack of relevance can be used to exclude evidence not because it has absolutely no bearing on or upon the likelihood or unlikelihood of a fact in issue but because the connection is considered too remote. Once it is regarded as a matter of degree, competing policy considerations can be taken into account. These include the *desirability of shortening trials*, avoiding emotive distractions or marginal significance, protecting the reputations of those not represented before the Courts and representing the feelings of a deceased's family. None of these matters would be determinative if the evidence were of significant probative value.[34]
>
> [author's emphasis]

[31]Constitution of the Commonwealth of Massachusetts, Article XI.

[32]See Commission notice on agreements of minor importance which do not appreciably restrict competition under Art 81(1) of the Treaty establishing the European Community (de minimis), 2001/C 368/07.

[33][1991] NZLR 707.

[34][1991] NZLR 707, 711 (emphasis added).

It is commonly observed in practice that a shorter case is more likely to be allocated a judge than a very lengthy case, both because there is a better chance of a short case starting and finishing within the estimated time, and because the disposal of a number of short cases reduces the list of pending cases more than the disposal of a lengthy case.

Finally, the concept of *res judicata* can be relied upon to bring definition to time in proceedings.[35]

16.2.12 Cost

There have been efforts in other jurisdictions, notably in the United Kingdom, to redress complexity where there is consensus that it does not work. Litigation is expensive and time consuming. The *Financial Times* reported that Britain's most expensive case to date was *Bank of England v. Liquidators of BCCI* which took 12 years and cost UK £110–120 million in legal fees with the initial claim size being UK £1 billion.[36] The same newspaper also reported on a rethinking of legal fees.[37] However, despite the increasing scrutiny and criticism of hefty legal fees, some lawyers also reported – what many lawyers have also experienced for themselves – that substantially less time is billed than actually spent working on the case.[38] Regardless, the reality is that complexity takes time and increases costs.

16.3 Complexity Strategies

All these intra-systemic flaws can be exploited for the purposes of strategic advantage in litigation. Those dealing in litigation as their profession will be aware of the pervasive influence of time and money on litigation. It is not a question of finding examples to demonstrate it since these factors are present in all litigation to a greater or lesser degree. By way of illustration of the range of impact, three examples are given below: (1) the interaction of civil and criminal litigation; (2) small consumer disputes; (3) multi-strand international strategy in an industrial sector (pharmaceuticals).

[35]But note Case C-234/04 *Kopferener v. Schlank and Schick* [2006] ECR I-2585 at paras. 19–24 where a national decision is subsequently clearly contrary to EC law, *res judicata* and the principle of legal certainty protect it from set-aside.

[36]M. Murphy, "Tajikistan Case Set to Test Fee Records", The Financial Times (1 May 2008).

[37]M. Murphy, "Time to Stop the Lawyer's Clock", The Financial Times (20 May 2008).

[38]Ibid.

16.3.1 Duality and Delay: "Sex Abuse Delay" Cases

In Ireland in the last 15 years there was an explosion of "sex abuse delay" cases, where persons being prosecuted for criminal acts of sexual abuse sought to injunct or prohibit, by way of civil judicial review proceedings against the public prosecutor, their criminal prosecution on the ground of the delay between the date of the alleged offence, and one or other relevant date in the prosecution, normally the date the prosecution was initiated (or the date on which the complaint was made, or the date on which the case was returned for trial). There is a certain complexity to these cases – Irish law has no statute of limitation for the prosecution of criminal offences on indictment, and some of the prosecutions related to matters up to and beyond 30 years prior to the prosecution. Issues of prejudice to the accused, and of repressed memory of victims due to the alleged dominance of the accused, received much attention. Many sensitive and important issues were involved. However on the sidelines of the jurisprudential inquiries was the strategic importance of the delay caused by the defendant in seeking to injunct the prosecution. So long as that civil law proceeding to injunct rolled on, no criminal prosecution could take place. Often, the alleged perpetrators were old. The longer the prosecution was stayed, the higher the probability that the accused would be unable to stand trial due to infirmity or death. This scenario, the use of aspects of the same system to create delay in a litigation proceeding is a litigation strategy in the classic sense – i.e. strategy that takes advantage by pitting one set of rules against another.[39]

16.3.2 Futility and Costs: The Soda Can Litigation Scenario

This old example is of the consumer who "loses" his coin to the automatic vending machine. He puts the money in, the soda can does not come out. He can shake the machine, but not to the point of criminal damage. If that doesn't work, he can hardly shake the system. Technically, of course, he could sue the soda company for breach of contract. No doubt he would get into difficulties about the correct identity of the Defendant: the manufacturer of the product, the manufacturer of the vending machine, the occupier of the premises on which the vending machine was situated, the distributor who ran the vending machine, etc. If he correctly identified the Defendant, and could prove his case, ultimately he would recover in contract or tort, the value of the coin he lost, but little more. The time and cost required to pursue a

[39]Legal strategies such as this are as old as the law itself. David Daube sets out examples from early Roman law of two mechanisms used in many ways to avoid what the law intends – the swap of an alternative transaction to the one restricted, and the *interposita persona* or man of straw, stating: "Essentially, all circumventions of a law are misinterpretations". See D. Daube, "Dodges and Rackets in Roman Law", D. Cohen, and D. Simon eds., *Collected Studies in Roman Law*, volume 2 (Klostermann, 1991) 1081–1082.

remedy via a litigation process is hardly worth the value lost. In practice, then, there is no real remedy for the frustrated soda can litigator.

From the perspective of a vending machine manufacturer, for example, strategic implications emerge – a risk calculation can be made as to what will provide the better bottom line: spending money on manufacturing a flawless vending machine or taking the risk of potential and, in this case, unlikely, consumer litigation.

By extension, such risk calculations could be applied to compliance: firms can voluntarily decide to impose excessive costs on consumers and thus while a seemingly small dispute may have profound consequences for society in general, it often cannot be litigated because of its disproportionate size to the litigant of the small claim.[40]

16.3.3 Resources and Risks: Pharmaceutical Industry's Litigation Stratagems

A 2008 preliminary report of the European Commission into the pharmaceutical industry's stratagems of delay and litigation aimed at preventing or delaying market competition indicated that the industry uses a combination of clusters of patent applications, litigation, threat of litigation on patents and settlements of litigation to restrict market access for generic drug manufacturers.[41]

Successful strategy must fully embrace the reality of litigation and its attendant characteristics. So, for example, people may not litigate certain types of claims due to their lack of resources. Thus, a well-resourced party may be encouraged to spin out a litigation to shake off an under-resourced litigant.

Similarly, litigation might be foregone when a complainant perceives it as pointless to their goals to achieve a result many years from the alleged injustice giving rise to the claim.

On the other hand, an impecunious litigant may be encouraged to bring a vexatious claim for the purpose of securing settlement from a well-resourced defendant, because that defendant would not be able to recover from the plaintiff, the cost of the defence in the event of its success. To be sure, settlement can often

[40]A judge of the Irish High Court recently called for the State to set up a scheme to meet the legal costs of people caught up in litigation of significant public importance. These comments were made in the context of a case that had originated in small claims court (the speediest, most informal court in the Irish system) concerning a claim for €130.50 and ended up in the High Court on a point of law which would affect 34,000 householders. The referral to the High Court made it difficult for the original litigant to contest the action due to the cost, and she applied for a guarantee for costs irrespective of outcome. However, Clarke J. ruled that the Court lacked the power to make such an order. *Rosborough & Anor. v. Cork City Council* [2008] IEHC 94 (High Court).

[41]European Commission, Pharmaceutical Sector Inquiry Preliminary Report, DG Competition Staff Working Paper IP/08/1829 (28 November 2008), online: Europa http://ec.europa.eu/competition/sectors/pharmaceuticals/inquiry/preliminary_report.pdf.

appear to be more desirable to both parties than litigation and its protracted costs. In such circumstances, it is in part a fear of the consequences of the system itself rather than the strength or weakness of the claim that promotes imperfect settlement as the better outcome.

These types of risk calculation perhaps stem from a realisation that justice is not a result, but rather an entire structure with its own injustices embedded within that structure.

16.4 Conclusion

Complexity is implicit in many academic discussions of the law but is often not explicitly addressed in and of itself. There are however a few examples, one being P. H. Shuck "Legal Complexity: Some Causes, Consequences, and Cures".[42] Shuck notes that complexity is an age-old concern within the law and is particularly noted in the public perception of the legal community. He argues that complexity is increasing in the law and that this is problematic for the administration of justice. In discussing the "political economy of complexity" he notes the role of career ambitions and craft values in the various legal professions and institutions. Shuck claims that an appreciation of the costs of greater complexity creates strong incentives towards simplification.

The legal system has failed in its disregard of the effects of the extent of its claims. The operation of the legal system – regardless of lawyers and law-makers not knowing what the law is, and the determination of law being an ordeal constituting its own wrong – belies its claims.

Modern legal systems lack the Rule of Law, because the subjects of the law are unable to identify the law. This is a large claim, but a true one. Furthermore, the Law often cannot be efficiently invoked and/or applied in litigation, for example, due to issues such as delay, cost, and legal and factual uncertainty. The legal process does not abide by the standards it requires of those subject to it. In this it has built-in hypocrisy. Indeed the law itself ceases to become a rule of conduct and has taken leave of the context in which it is supposed to guide.

It is not a question of tinkering with the system, or for head-shaking jadedness at the incurable morass of legal administration, or setting up another agency or task force to consolidate this or that section of the law (not in itself to be discouraged). The flaw is systemic. The exploitation of these flaws, given that they dominate the course of litigation, is the dominant litigation strategy.

[42](1992) 42 Duke Law Journal 1; Other examples include: Barton (n 4); E. Kades, "The Laws of Complexity and the Complexity of Laws: The Implications of Computational Complexity Theory for Law" (1997) 49 Rutgers Law Review 403; and J. Stempel, "A More Complete Look at Complexity" (1998) 40 Arizona Law Review 781.

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Chapter 17
Evidence Collection as a Legal Resource for Strategy: A French and European Perspective

Thibault du Manoir de Juaye

Abstract In this chapter, the author discusses a number of evidential strategies and considerations that might be adopted or explored to increase the chances of success in litigation. To this end, particular focus is given to the laws applicable to digital data.

17.1 Introduction

These days reference is often made to the "judicialisation"[1] of society and its undoubtedly numerous causes. From a management point of view, society's judicialisation has translated into "litigation risk" and is being taken into account by entrepreneurs in much the same way as industrial or financial risk. Indeed, the awareness of litigation risk has been steadily increasing, the expression itself having become a common catch-phrase in many newspapers and financial journals.[2]

The reasons behind this increase in corporate attention to litigation risk include:

- The internationalisation of commerce: Internationalisation is leading companies to adopt practices and customs of the countries with which they trade. For example, practices from the United States, the world's most powerful economy, tend to rub off on their trading partners.
- Judicial intervention in the world of business: Recently, the judiciary have been called upon to adjudicate various political and financial scandals which have been making headlines in recent years.

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[1]Tendency for society to be increasingly likely to take legal action.

[2]See B. Cerveau, "Le risque juridique: affaire de spécialistes ou de gestionnaire de risques" (23–24 février 2001) Gazette du Palais.

A. Masson and M.J. Shariff (eds.), *Legal Strategies*,
DOI 10.1007/978-3-642-02135-0_17,

- Criminal sanctions against businesses: The number of offences continues to grow and penalties are becoming heavier. Entrepreneurs are disturbed to find themselves before the criminal courts and are increasingly taking steps to protect themselves. For example, one of the major overseas audit firms in Paris has created a department dedicated to criminal risk which is presided over by a former judge from the Paris financial investigations division.[3]
- Quasi-recession / sluggish growth in recent years: Any decision by an entrepreneur involves an analysis of return on investment. In prosperous periods, an entrepreneur is better off devoting financial resources to production and sales. During times of crisis, a lawsuit might bring in more money than the business operation. Moreover, in such periods, companies seek to recover small debts which, in better times, might simply have been ignored.[4]
- Continual increases in standards, to which businesses must submit or else bear the potential risks of not complying, including the possibility of going under.

Faced with the inevitability of proceedings at some point in the future, a company should consider how it can increase its chances of winning a case. Notwithstanding the influence of the quality of lawyers or the relevance of a line of argument, most cases are won on evidence.[5] Therefore, in dealing with litigation risk, the company would do well to turn its mind to preparing its evidential strategy.

17.2 Some Preliminary Considerations

Evidence is increasingly digital – it can move from one country to another and usually at the choice of information technology (IT) technicians rather than lawyers. This digital mobility, so to speak, carries major consequences with respect to privacy, confidentiality, accessibility, seizure among others. Matters are further complicated by the movement of digital information across borders, which necessarily involves at least one other legal system, despite increasing efforts towards international harmonisation.

Because the numerous laws applied by French courts are essentially international, an examination of evidence management under French law is of particular

[3]Similarly, Ernst & Young, International has taken on a former judge, Anne Josée Fulgeras as its principal director. See C. Matlack, G. Smith, and G. Edmondson, "Cracking Down on Corporate Bribery" (6 December 2004) Business Week, online: Cracking Down http://www.businessweek.com/magazine/content/04_49/b3911066_mz054.htm.

[4]See P. Keel, D. Bishop, and N. Lucas, "Australia: Top 10 Developments in Commercial Litigation In 2008" (08 January 2009) Mondaq discussing how economic downturn has triggered a rise in litigation.

[5]See for example, C. Champaud, and D. Danet, *Stratégies Judiciares de l'Entreprise* (Dalloz, 2006).

interest to this chapter, as the resulting juridical strategy might be applied in different jurisdictions.

17.2.1 Factual Considerations

French civil and commercial courts have, for a number of years, been faced with increasing demands for authorisation to search for evidence, particularly with respect to matters appearing or recorded on digital media. There are several reasons for this increasing demand, which include the following:

- The transitory nature of evidence on digital media: For example, how can the receipt of an e-mail or the existence of a document be proven?
- The difficulties encountered in producing evidence (of one's own), because of the rules regarding the collection and conservation of information. In effect, evidence not obtained according to law cannot be adduced in the courts. For example, if a file containing personal information has not been declared to CNIL (the data-protection and privacy regulating authority in France), its contents cannot be used in the courts.[6]
- The opportunity under French law to reverse the burden of proof.[7]
- The internationalisation of the economy, causing dispersal of evidence in different countries.

For example, a seizure of a Google e-mail box in France cannot be executed when the data is held by Google Ireland or Google USA, where execution of the seizure might become more complicated. A typical response to this type of evidence dispersal includes extending the reach of a regulatory arm. For example, many provisions of the *Sarbanes-Oxley Act*, adopted by the US Congress in July 2002,[8] grant certain powers to the United States (US) authorities over companies located outside their national territory, even at the risk of encroaching on the national sovereignty of other jurisdictions.[9]

[6]See for example, Cour Cass. (13 janvier 2000) *CPH Paris* and Cour Cass. (6 avril 2004) *Allied Signal Industrial Fibers*; See also Decision RG F06/01121 *Société DMF* [*Société DMF*].

[7]See for example, Article 1152 of the French Civil Code, as to the excessive nature of penalty clauses.

[8]Sarbanes-Oxley Act of 2002 (Pub.L. 107-204, 116 Stat. 745) enacted 30 July 2002 and also known as the Public Company Accounting Reform and Investor Protection Act of 2002.

[9]See N. Rontchevsky, "L'Onde de Choc des Scandales Financiers Américains Atteint l'Europe: l'Effet Extra-territorial du Sarbannes-Oxley Act du 30 juillet 2002" (2002) 4 Revue Trimestrielle de Droit Commercial (RTD Com) 700.

17.2.2 Admissibility Considerations

In Roman-Germanic legal systems, evidence is governed by strict rules. Litigants must comply with these rules if they want to enforce their rights before a national court. For example, Article 9 of the *French Code of Civil Procedure* (*CPC*), states the general principle applicable before all civil courts:

> Each party shall establish *according to law*, the facts required for the success of its claim.[10] [author's emphasis]

In other words, it is impossible to adduce evidence before a French civil court that was unlawfully created, obtained or retained. Conversely, this principle does not exist in criminal proceedings. In effect, under Article 427 of the French Code of Criminal Procedure:

> Except where the law otherwise provides, offences may be proved by *any mode* of evidence and the judge decides according to his innermost conviction . . ..[11] [author's emphasis]

That being said, however, both the civil and criminal provisions are supplemented by many decisions of the French Supreme Court, the *Cour de cassation*, which requires that all evidence be lawfully obtained. To support the imposition of this requirement, the Supreme Court principally relies on Article 6, paragraph 1 of the *Convention for the Protection of Human Rights and Fundamental Freedoms*, the "right to a fair trial".[12] In this regard, in 2008, the Supreme Court quashed a 2007 judgment of the Court of Appeal of Paris, which had convicted certain companies of offences that were proved by recordings of telephone conversations made without the knowledge of one of the parties thereto.[13]

[10]Code of Civil Procedure, Section IV Evidence, Art. 9, online: Legifrance http://www. legifrance.gouv.fr [CPC].

[11]French Code of Criminal Procedure (Code de Procédure Pénale), Art. 427, online: Legifrance http://www.legifrance.gouv.fr/.

[12]*Convention for the Protection of Human Rights and Fundamental Freedoms as amended by Protocol No. 11*, Rome, 4.XI.1950, Article 6, para. 1: "In the determination of his civil rights and obligations or of any criminal charge against him, every person is entitled to a fair and public hearing within a reasonable time by an independent and impartial tribunal established by law. Judgment shall be pronounced in public, but the press and public may be excluded from all or part of the trial in the interests of morals, public order or national security in a democratic society, where the interests of juveniles or the protection of the private life of the parties so require, or to the extent strictly necessary in the opinion of the court in special circumstances where publicity would prejudice the interests of justice".

[13]See Cass. (3 June 2008), No.07-17.147, 07-17.196.

17.3 Evidence as a Resource for Strategy

Faced with the emergence of both factual and legal requirements for the management and admissibility of evidence, companies and/or their advisers should, in preparation for any future legal proceedings, carefully consider the use of their information systems for probative purposes and should also consider what additional measures might be taken. It is apparent that these potential measures revolve around two central questions, namely:

- What are the rules for collecting and conserving data?
- How can evidence be obtained within a legal framework?

The answers to these questions will first be addressed from the perspective of French law and then placed in a broader context. It is essential to understand what happens on French territory, before considering international implications.

17.3.1 The Collection of Evidence Under French Law: Article 145 CPC

Contrary to a widely-held belief in many Anglo-Saxon countries, French legislation, as with other countries with Roman-Germanic law, contains numerous provisions akin to procedures for discovery which enable the collection of evidence before trial. These provisions are particularly apparent in the *French Intellectual Property Code*[14] which was recently amended to include, *inter alia*, several paragraphs dealing with the collection of information for the purpose of defining the boundaries regarding breach of copyright.

The *CPC* also contains several provisions concerning evidence, the most controversial being Article 145 making it particularly interesting to examine.

Article 145 provides as follows:

> If there is a legitimate reason to preserve or to establish, before any legal process, the evidence of the facts upon which the resolution of the dispute depends, legally permissible preparatory inquiries may be ordered at the request of any interested party, by way of application or summary procedure.[15]

From the outset, many courts were quite liberal in granting Article 145 orders. In more recent months however, the conditions for obtaining orders for investigatory measures have been considerably restricted and the courts of Paris have even begun to innovate at the boundaries, or so rumour has it, outside the ambit of the *CPC*.[16]

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[14]Intellectual Property Code (*Code de la Propriété Intellectuelle*) as amended by law No. 2007-1544 of 29 October 2007, online: Legifrance http://www.legifrance.gouv.fr/.

[15]CPC (n 10) Art. 145.

[16]See for example, Cass Com. (11 December 2007) RG No. 07-2184 and RG No. 07-80988.

17.3.1.1 Pre-conditions Required Prior to the Operation of Article 145

Notwithstanding its apparent broad scope, the operation of Article 145 assumes that certain pre-conditions have been met or satisfied. These are: the "legitimate interest" of the claimant; compliance with the *inter partes* principle; and a pre-trial application.

Legitimate Interest

Pre-trial collection of evidence requires a legitimate interest. Although legitimate interest can be a flexible concept, according to French courts, the Applicant under Article 145 must demonstrate the existence of a plausible or potential future dispute[17] and that there is a genuine risk of degradation of the evidence. Failure to establish a legitimate interest will lead to dismissal of the application. Thus for example, the French Supreme Court in 2008 confirmed the dismissal of an application for the appointment of an expert to determine the amount of compensation for an eviction because, as matters then stood, not even a potential dispute existed.[18]

Compliance with the *Inter Partes* Principle

In a number of judgments in principle dated 7 May 2008,[19] the French Supreme Court decided that no application under Article 145 could be granted, unless, apart from the other conditions required therein, both an emergency and non-compliance with the *inter partes* principle were demonstrated.[20] Pursuant to this principle, it is impossible, save via a motion to the judge, to examine a document or argument which has not been submitted for review by all parties involved in the dispute. Indeed, until recently, most decisions under Article 145 authorised the seizure of items and documents. This is typically the case under Roman-Germanic legal

[17]See Court of Appeal, Paris, (31 October 2007) *Société Blanc et Société COFIN audit* JurisData: 2007-347268; See also Court of Appeal, Rouen, (26 June 2007) *Société Copernit* JurisData: 2007-340864; See also Court of Appeal, Bourges, (5 April 2007) *Vallière Bilbeau Leclerc* JurisData: 2007-335907.

[18]Cass, 3ème civ. (16 April 2008) *Viennot de la Forest Divonne c/ SARL au Palais Gourmand* No. 07-15.486, dismissed.

[19]See Cass. 701 FS-D; 702 FS-D; 703 FS-D.

[20]See Cass. (7 May 1982), *Ste Generale c/ Fransucre et Autres* – Cass, 2e civ. (9 November 2000) No. 98-10.549 – Cass. 1re Civ. (9 Feb. 1983): JCP G 1983, IV, 132, Bull. civ. 1983, I, No.56, Gaz. Pal. 1983, 1, pan. jurispr. 178, note S.G, RTD civ. 1983, 783, obs. Normand – Cass. Comm. (25 Oct. 1983): JCP G 1984, IV, 6, Bull. civ. 1983, IV, No.275. – CA Paris (3 and 22 June 1983) RTD civ. 1983, 783, obs. Normand. – TGI Paris (26 Oct. 1984), Gaz. Pal. 1984, 2, 738, note Ph. B. – CA Versailles (16 Apr. 1986), D. 1986, inf. rap. 298. – CA Paris (26 May 1988), D. 1988, inf. rap.18 cited by Xavier Vuitton, Jurisclasseur procedure civile Fasc. 474. The requirement for urgency seems to be a reversal of view, since the Supreme Court had formerly held to the contrary.

procedure, which is more dependent on written material than on the hearing of witnesses. The courts therefore often order Court Officers, where appropriate, to attend when an expert goes to a third party's premises to take copies of digital (for example, the contents of an e-mail box) or paper documents. Some of the items seized may have nothing to do with the dispute or may be covered by professional secrecy (for example, client correspondence with its legal adviser) or may be considered confidential information. Hence, their handing over to the Applicant could be prejudicial to the person subject to the seizure. Consequently, since early 2008, Paris courts have prohibited Court Officers who have effected a seizure from remitting seized items to the Applicant until they have been examined at a hearing, during which the person subject to the seizure may raise any objections as to the confidential nature of the items seized. An *inter partes* argument is then held with the Applicant, after which the judge decides on disclosure or non-disclosure of the items seized. If the party does not comply with this *inter partes* process in circumstances amounting to an emergency then this requirement will be deemed to have been complied with and will not act as a bar to the Article 145 application.

Pre-trial Application

The Article 145 application must be made "before any trial". This begs the question: "at what date might one consider proceedings to have started?" There are several possible dates that might be considered, for example, the date of issue of the writ; the date of listing in the court's cause list; or the date of the first hearing. However, in a decision dated 26 June 2006, the French Supreme Court held that the date of listing of the hearing on the merits should be adopted as the appropriate event.[21]

Consequently, after a decision has been made by the court, it is impossible to seek information about a debtor for the purpose of enforcement proceedings under Article 145.[22] However, where the cause has been listed without a court or pre-trial judge being designated, the presiding judge of the court shall be competent to hear an application under his general powers. As from the designation of a pre-trial judge, such judge will be competent under Article 138, *CPC*.[23]

[21]Cass. 2e Civ. (28 June 2006) No.05-19.283.

[22]CPC (n 10) Art. 145: "If there is a legitimate reason to preserve or to establish, *before* any legal process, the evidence of the facts upon which the resolution of the dispute depends, legally permissible preparatory inquiries may be ordered at the request of any interested party, by way of a petition or by way of a summary procedure"; See also Cass. 2e Civ. (3 Feb. 2003) JCP G 2003, IV, 1624; Juris-Data No.2003-017579.

[23]CPC (n 10) Art. 138: "If, during the proceeding, a party wishes to rely on a notarial deed or a deed under private signature to which he was not a party or a document held by a third party, he may request the judge, to whom the matter is referred to, to order the delivery of a certified copy or the lodging in court of the deed or the document".

17.3.1.2 Rejection of the Trade Secrecy Exception

A number of "victims" of an investigatory measure taken under Article 145 have tried to rely on trade secrecy to avoid its application. However, the French Supreme Court decided in early 1999 that trade secrecy is not an argument capable of prohibiting applications under Article 145.[24] Similarly, professional secrecy cannot be raised as an objection to the application of Article 145.[25] For example, the shareholders of a company whose share price had suddenly dropped – even though optimistic information had been previously published and endorsed by the auditors – were able to ascertain the conditions in which the auditors had carried out their duties, without the auditors being able to invoke and rely on professional secrecy.[26]

17.3.1.3 Types of Investigatory Measures Under Article 145

Article 145 concerns any measures that might be taken which tend to conserve or establish evidence of the facts. Under Article 145, application may be made for the appointment of an expert, a Court Officer's report, or even sequestration, as was decided by the Court of Appeal of Paris in a judgment concerning a magnetic tape-recording of an interview.[27] Similarly, it is also possible to order, subject to potential penalties, the production of documents by the opposing party.[28] Under this article, a court has even gone so far as to order the opening of a safe on private premises.[29]

17.3.1.4 Problems of Territoriality

The judge territorially competent is either that of the court competent to decide the merits of the case and/or that of the place of execution of the applied for measure. Therefore, if the judge on the merits is French, he or she may be persuaded to order an investigatory measure abroad.

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[24]In this case, a car company was selling "new second-hand" vehicles at a price less than that offered by the brand dealer. The Court considered that a competing company was entitled to check whether its vehicles had been registered and held that trade secrecy could not be raised as an objection thereto.

[25]Moreover, an analysis of several court decisions shows that trade secrecy is often invoked, whereas this notion is not clearly defined in French law [Research on file with the author].

[26]See Cass. Comm. (14 November 1995) *Societe Fiduciaire de France KPMG audit c/ Faure*.

[27]CA, Paris, 1ere Chambre (5 February 1986).

[28]See Cass. Civ. 1ere Chambre *Civ*. (7 January 1999) *VERICAR c/ Gauduel Grenoble Nord*.

[29]See Order of TGI of Nanterre (21 April 2005).

The procedure for obtaining evidence in a foreign country arises, in principle, under the *Hague Convention of 18 March 1970* (the *Convention*).[30] Article 1 thereof provides:

> In civil or commercial matters, a judicial authority of a Contracting State may, in accordance with the provisions of the law of that State, request the competent authority of another Contracting State, by means of a Letter of Request, to obtain evidence, or to perform some other judicial act.
>
> A Letter shall not be used to obtain evidence which is not intended for use in judicial proceedings, whether commenced or in contemplation.
>
> The expression "other judicial act" does not cover the service of judicial documents or the issue of any process by which judgments or orders are executed or enforced, or orders for provisional or protective measures.

Hence, international interrogatories may be used to procure an investigatory measure in another State.[31] For example, a French judge,

> may, on application by the parties, or *ex officio*, procure an investigatory measure in a foreign State and other judicial acts he considers necessary, by issuing interrogatories either to any competent judicial authorities of such State or to French diplomatic or consular authorities.[32]

A request for international interrogatories must first be addressed to a central authority.[33] It is then executed in accordance with the law of the authority requested,[34] provided that the foreign court has not required compliance with a particular form. The interrogatories must be carried out with urgency and may only be refused under certain circumstances. The use of interrogatories is not, however, the only means of obtaining evidence. Other procedures, no less restrictive, are possible. The *Convention* provides, under certain conditions, the opportunity for diplomatic or consular agents and commissioners to effect investigatory measures:

- For the obtaining of evidence by diplomatic or consular agents: authorisation by the French authorities, for example, will be required where nationals of France or third-party countries are to be questioned; whereas, if the persons to be

[30]The *Convention on Taking of Evidence Abroad in Civil or Commercial Matters* (Concluded 18 March 1970), online: HCCH http://www.hcch.net/index_en.php?act=conventions.text&cid=82 [Hague Convention].

[31]In France, international interrogatories are governed by CPC (n 10) Title XX, Chapter II, Sections I and II, Arts. 733–748.

[32]CPC (n 10) Title XX, Chapter II, Section I, Art. 733.

[33]In France, this authority is the Office of International Judicial Cooperation of the Ministry of Justice.

[34]For example, in France, see CPC (n 10), Art. 739: "Interrogatories shall be executed in accordance with French law, provided that the foreign court has not required that it shall comply with a particular form. If so requested in the interrogatories, the questions and answers shall be fully transcribed or recorded".

questioned are nationals of the requesting state, prior approval by the French authorities will not be necessary.[35]

- For the obtaining of evidence on commission:[36] prior authorisation from the central authority of the State of execution[37] will always be required, whatever the nationality of the person to be heard.

Furthermore, the question of the exclusiveness of the *Convention* is, naturally, raised for certain countries somewhat disinclined to follow such procedures. This, of course, includes the United States, whose pre-trial discovery procedure runs counter to the provisions of the *Convention*. The question is therefore simple: may the court determining a dispute use its own internal rules of procedure to obtain documents or the evidence of witnesses abroad? Or must it, for this purpose, as the *Convention* requires, issue a requisition to the competent judicial authority?

The United States has decided not to regard the *Convention* as binding. On the other hand, Germany considers the *Convention* as excluding any other procedure. Historically, France took a more ambiguous position but has finally opted for application of the provisions of the *Convention*. Indeed, by adoption of the law of 16 July 1980[38] (which prohibits the provision to foreign individuals or corporate entities of any economic, commercial, industrial, financial or technical documents and information), the French Parliament's principal objective, in respect of foreign proceedings, is that the procedures for obtaining evidence prescribed by internal French law or international conventions, principally the *Convention*, be complied with in France. This law has therefore made application of the *Convention* exclusive. However, a 1993 decision of the Court of Appeal of Versailles[39] raised certain doubts, when it held that "the Convention, far from concerning the administration of evidence as a whole, only governs interrogatories". The Court further considered that "a measure concerning proof may be freely accomplished, provided it is unlikely to infringe the sovereignty of the State".[40] Despite this decision, it would seem appropriate to conclude that an order by a French judge for an investigatory measure may only be executed in another State through interrogatories, and vice-versa.

[35]Hague Convention (n 30) Arts. 15 and 16.

[36]Ibid Art. 17.

[37]See (n 33).

[38]Article 1b (*1er bis*) of Law No. 80-538 of 16 July 1980 requires compliance with treaties or international agreements and the laws and regulations in force in France, including the CPC (n 10) and the provisions of the Hague Convention of 18 March 1970 (n 30) concerning the obtaining of evidence abroad in civil and commercial matters, ratified *inter alia* by France and the United States.

[39]CA Versailles, (9 April 1993) *Ste Luxguard c/ Ste SN Sitraco*.

[40]Ibid.

17.4 European Regulations

In Community law, Council Regulation (EC) No. 1206/2001 of 28 May 2001 (the *2001 Regulation*) concerns cooperation between the courts of Member States in the taking of evidence in civil or commercial matters.[41] The *2001 Regulation* establishes two systems for obtaining evidence between Member States:

- Direct notification of requests between courts
- The direct obtaining of evidence on the part of the requesting court

In either case, the investigatory measure may be executed on the spot or remotely (by videoconference, for example). In application of the provisions of the *2001 Regulation*, in particular, Article 1, paragraph 2, it seems that it may be possible, under Article 145 *CPC*, to apply to a French judge to order an investigatory measure *in futurum* to be executed in another Member State.

However, the *2001 Regulation* adds a supplementary condition to those existing under Article 145 – any person applying for conservation of evidence shall indicate the procedure he or she intends to undertake on the basis of such evidence.[42] As a general rule, the court requires the application to be executed in compliance with the law of the Member State from which it arises.[43] It may also, however, execute the application in accordance with a special form prescribed by the law of the Member State of the requesting court. The law applicable to coercive measures required for the execution of a request is determined in compliance with the law of the Member State of the requested court, insofar as such law prescribes them for the execution of a request for the same purposes issued by a national authority of the said Member State or of one of the parties concerned.[44] It should be stressed that the direct execution of the investigatory measure is only possible if it can be carried out on a voluntary basis, without the need for recourse to coercive measures.[45]

17.5 Conservation of Information for Probative Purposes

Two of the main obstacles to adducing information in the courts are: non-compliance with provisions applicable to private life; and the legal requirements as to the supervision of employees. Advocates now do not hesitate to apply to the courts to exclude numerous documents. Such applications should usually succeed, since, from

[41]Council Regulation (EC) No. 1206/2001 of 28 May 2001 on cooperation between the courts of the Member States in the taking of evidence in civil or commercial matters, online: European Commission http://ec.europa.eu/civiljustice/homepage/homepage_ec_en.htm [2001 Regulation].

[42]Ibid art. 4, paragraph 1(c).

[43]Ibid art. 10, paragraph 2.

[44]Ibid art. 13.

[45]Ibid art. 17, paragraph 2.

a practical perspective, they serve to reduce the volume of files, which have steadily increased since e-mails first took off. In support of this speculation one might look to a 2008 decision by the Nanterre Employment Tribunal, the Conseil de prud'hommes. In a particularly well-reasoned judgment, the Conseil considered that an employer could not dismiss a salesman for inadequate performance based on information generated from the company's sales management software, on the basis that the digital processing had not been declared to the French National Commission for Data Protection and Privacy (or CNIL),[46] which applies the *Data Protection and Privacy Law of 6 January 1978* [the *1978 Data Protection and Privacy Law*].[47]

17.5.1 Data Protection and Privacy Law

Well before the adoption of *European Directive No. 95/46/EC dated 24 October 1995*[48] [*European Directive*] and the *European Convention of 28 January 1981*,[49] France had, on 6 January 1978, passed a law regulating the collection and conservation of personal data – the *1978 Data Protection and Privacy Law*. Since its inception, this law has been amended several times, most recently by *Law No. 2006-64 of 23 January 2006*.[50] Processing any data of a personal nature[51] is subject to the *1978 Data Protection and Privacy Law* as follows:

[46]See (n 6).

[47]The *Data Protection and Privacy Law of 6 January 1978* is officially called Act no. 78-17 of 6 January 1978 on Data Processing, Data Files and Individual Liberties, online: CNIL http://www.cnil.fr/fileadmin/documents/uk/78-17VA.pdf [1978 Data Protection and Privacy Law].

[48]Directive 95/46/EC of the European Parliament and of the Council of 24 October 1995 on the protection of individuals with regard to the processing of personal data and on the free movement of such data, Official Journal L 281, 23/11/1995 P. 0031 – 0050.

[49]Convention for the Protection of Individuals with regard to Automatic Processing of Personal Data, Strasbourg, 28.I.1981.

[50]See Loi no. 88-227 du 11 mars 1988, (French Official Journal of 12 March 1988); Loi no. 92-1336 du 16 décembre 1992, (French Official Journal of 23 December 1992); Loi no. 94-548 du juillet 1994, (French Official Journal of 2 July 1994); Loi no. 99-641 du 27 juillet 1999, (French Official Journal of 28 July 1999); Loi no. 2000-321 du 12 avril 2000, (French Official Journal of 13 April 2000); Loi no. 2002-303 du 4 mars 2002, (French Official Journal of 5 March 2002); Loi no. 2003-239 du 18 mars 2003, (French Official Journal of 19 March 2003); Loi no. 2004-801 du 6 août 2004 (French Official Journal of 7 August 2004); Loi no. 2006-64 du 23 janvier 2006, (French Official Journal of 24 January 2006).

[51]However, information collected in France via a website is often used in another country. How then is the applicable law to be determined? One of the criteria to be taken into account, apart from any procedural aspects for the localisation of data, is the legal protection which may be extended to the data. In other words, which country provides the most effective basis in law for pursuing individuals who have wrongfully appropriated data? Most countries of the former Soviet bloc which have recently joined the European Union have adopted legislation almost identical to that of the USA on economic espionage. See the special issue on economic intelligence edited by the author in the *Cahier de Droit de l'Entreprise* (September 2008), No. 5.

> Where the person responsible is established in French territory: the person responsible for processing, who acts on French territory within the framework of an installation, whatever the legal form thereof, is deemed to be established;
>
> Where the person responsible, without being established in French territory or in that of another Member State of the European Community, uses processing resources located in French territory, to the exclusion of processing used only for the purpose of transit into this territory or into that of another Member State of the European Community.

The European Directive was also concerned with confirming that any processing would comply with the law of the Member State in which the person responsible for the file had his or her principal place of business. The problem is therefore to define the meaning of "processing". With respect to the French concept of processing, it is likely to provoke conflicts of law. Indeed, Article 2, paragraph 3, of the *1978 Data Protection and Privacy Law* (as amended), provides that:

> Processing data of a personal nature means any operation or group of operations of any kind concerning such data (personal data), including the collection, recording, organisation, conservation, adaptation or alteration, extraction, consultation, use, communication by transmission, dissemination or any other form of provision, access or interconnection, as well as locking, deletion or destruction.

The principle of French law is simple: subject to a number of exceptions, the automated processing of data used for other than private purposes and including personal information must be declared to CNIL, which has a power to impose sanctions. Article 5 of the *1978 Data Protection and Privacy Law* provides:

> The automated processing of personal information means any operations effected by automatic means, for the collection, recording, preparation, alteration, conservation and destruction of personal information and any operations of the same kind relating to the use of files or databases and including the interconnecting or accessing of any consultation or communication of personal information.

In a decision *N c/ Nouvelle Frontière* dated 5 February 2004, the CNIL observed that:

> Electronic addresses generally have a personal character and the functionalities provided by e-mail software (such as Outlook) enable the organising, sorting, finding and storing of messages (for example, according to their sender, addressee or purpose).

Further, the Superior Court of First Instance (TGI) of Versailles considered that the creation of a simple Excel file with financial information about employees by a director of human resources was unlawful.[52]

The field of application of the law in this area is very extensive and raises the possibility of numerous exclusions of documents by the courts.

[52]See TGI Versailles (4 March 2002) Jurisdata: 2002-203249 – Court of Appeal Nancy (25 June 2001) Jurisdata: 145997 – TGI Paris (13 Sept. 1995) Dr. pén. 1996, comm. 32, obs. M. Véron, Expertises, Dec. 1996, no. 446, obs. J. Frayssinet; – Cass. Soc. (7 June 1995) *CGT Turbomeca c / Turbomeca*.

17.5.2 Employment Law

The French Employment Code, *Code du travail*, imposes strict conditions for surveillance of employees. If these conditions are not complied with, the employer will be unable to use any material obtained by the surveillance. There are three such conditions:

1. The means of surveillance must be proportional to its purpose.[53]
2. The employee must be informed before any surveillance measures are taken.[54] However, such information is insufficient, where the evidence emanates from a system not intended for surveillance of the employee – for example, a video surveillance system intended to ensure the security of storage areas where the employee is not supposed to go,[55] the auditing of telephone communications by examination of telephone bills,[56] etc.
3. The means of surveillance must be brought to the attention of the Works Council (*Comité d'entreprise*).[57]

17.6 Conclusion

Legal strategy in an international litigation environment has hitherto for the most part been based on simple concepts, such as choice of law or jurisdiction. It has also at times incorporated a wider platform and has benefited from such things as:

- Media coverage (for example, on victimisation)
- Lobbying (for example, a judgment demonstrating the vacuousness of a law or its contradiction with higher standards, resulting in a need to change the law at the root of the order)
- Destabilisation

[53]Art. L. 120-2 of the French Employment Code provides that: "No restrictions unjustified by the nature of the task to be accomplished or disproportionate to the end to be achieved may be imposed on personal rights or individual or collective freedom".

[54]Ibid Art. L.121-8: provides that "No information personally affecting any employee or candidate for employment may be collected by any system or device which has not beforehand been brought to the notice of the employee or candidate for employment".

[55]See Cass. Soc. (31 January 2001) TPS.

[56]See Cass. Soc. (11 March 1998) Jurisdata: 1998-001398, Bull. civ. V, 15 May 2001, No.168.

[57]The Works Council is the body within the company representing the staff. See French Employment Code Art. L.432-2-1, paragraph 3: "the Works Council shall be informed and consulted, in advance of any decision within a company to implement any resources or techniques enabling surveillance of the activity of employees".

Practitioners have now become aware that legal strategy from the perspective of litigation can only be truly effective via the management of evidence, without which no litigant can establish his or her rights.

Such management involves at minimum, the following stages:

1. The analysis of principal contracts with, for example, the SWOT (strengths, weaknesses, opportunities, threats) method. Well known by economic intelligence advisers, the SWOT analysis should reveal whether, having regard to the importance of the contract at issue, it would be appropriate to build it into the system for management of the evidence.
2. The analysis of any extra-contractual risks and an analysis of the need for evidence.
3. A determination of the evidence required and the identification of evidence in the possession of or to be produced by the litigant.
4. For the latter evidence identified immediately above: a determination of its legal status, particularly as dependent on its localisation. If the applicable law is unfavourable, transfer the data, where appropriate, to a country with a more favourable legal system.
5. Provide for evidence in contracts, where appropriate, with a view to its contractual management, taking into consideration the following elements:

    - Possibility of reversal of the burden of proof.
    - Obligation of one party to provide information.
    - Localisation of the information, so as to be able to benefit from a more favourable system.
    - Evidence which the company does not and cannot possess. For example, exchanges between third parties: determine the procedure for obtaining it, along with identification of the competent court.

For certain companies, management of the evidence will be fairly simple, because the contractual relationship with their clients is also simple. For example, a company providing consumer credit has to show that it was informed of the solvency of the debtor before the contract came into existence, that a contract complying with the regulations has been concluded and that the funds have been provided. The management of the evidence therefore consists of the material management of documents and compliance with privacy regulations which seems reasonably simple to achieve. For other companies however, strategic management of evidence is much more difficult, particularly with regard to the internationalisation of the law applicable to data and the uniqueness of each contractual relationship.

Indeed, in the majority of cases, management of evidence is complicated partly because of the sheer "volume of documentation" and partly because of the need to authenticate digital information, which, as everybody knows, is easy to manipulate. To these two parameters (volume and ease of manipulation), it is appropriate to add a third, that of the applicable law. For an internet user, whether information is located in Europe, the United States or Asia is of no concern, so long as it is easily and rapidly accessible. For the lawyer, the situation is quite different, since the

localisation of the processing of the information and/or of its visual display determines the applicable law(s).

The French example regarding the collection of evidence discussed above underlines the difficulties in devising a strategy for evidence for the purpose of defining the localisation of evidence and hence the applicable law, including the law(s) applicable to investigatory measures in the future (notwithstanding that international conventions and European regulations facilitate such collection of data). Even so, the example provided does suggest a way forward.

Consequently, because evidence is the indispensable foundation for any trial strategy, litigants need to think carefully when devising a strategy for evidence. One may laconically restate the imperative need for such a legal strategy as follows: "in court: no evidence, no success!"

Chapter 18
Transnational Transactions: Legal Work, Cross-Border Commerce and Global Regulation*

Doreen McBarnet

Abstract This chapter demonstrates the problem-solving nature of creative legal work, focussing on an example of how cross-border transactions in emergent economies have been satisfactorily constructed in the absence of established local law and regulation. Lawyers use contract to create private regulatory structures as surrogates for state or international controls. The chapter however, also demonstrates the negative consequences of legal creativity, which is routinely used not to replace regulation but to circumvent it. Though legal creativity can be a force for regulation, the driving force behind it – innovation for competitive advantage – is more likely overall to frustrate regulation than to promote it.

18.1 Introduction

The topic of law in a global economy is commonly framed as a problem. It is framed as a problem for the *regulation* of transnational business, in the absence of unified norms and global authorities to enforce them. It is also framed as a problem for the *transaction* of transnational business in the face of the conflicting demands of multiple jurisdictions, or in the face of massive "gaps" in the commercial law of, for example, emergent markets. This chapter focuses on the second of these issues, on the legal aspects of *doing business* transnationally, but it has significant implications for transnational *regulation* too.

The research on which this is based was prompted by an apparent paradox. The dominant discourse on global business law is couched in terms of the major

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problems posed for business by cross-border legal gaps and clashes, and the urgent need to resolve them. Resolution is seen as a matter for international policy and institutional development, in particular by constructing, or constructing further, a global framework of laws or pseudo-laws.[1] In the meantime, however, the global economy appears to be thriving. The empirical reality is that business goes on. Cross-border deals are proceeding, on a massive scale, with or without cross-border law – and they are proceeding as *legal* constructs.

How are these deals legally accomplished in the absence of a fully developed framework of global law? The key to this lies in *legal work*, and the role of legal work in transnational transactions. By "legal work" I mean technical work, with and on the law, undertaken usually but not necessarily by lawyers, in specific transactions for specific clients. This is a remarkably under-researched aspect of law whether global or domestic.

To focus research on legal work in a global economy, is to adopt a rather different perspective from the main body of transnational research, since it homes in on legal and business practice at the micro-level. There is a good deal of debate and research on the need for, or construction of, shared global norms and global institutions to make or enforce them.[2] The focus here is on the macro-level and on collective action, whether by states, business associations, legal firms or non-governmental organizations to produce legal, or pseudo-legal, structures.[3]

My research, by contrast, focuses on action at the level of the individual business deal, on the law firm's work for its individual client in specific global transactions. It looks at technical legal work at the micro-level.[4] But it also has implications for macro-level analysis. It shows how problems at the macro level are resolved at the micro level. Legal work produces micro-solutions for macro-problems. At the same time, demonstrating how the micro can affect the macro suggests some less benign consequences. If legal work can produce micro-solutions to macro-problems, it also has the potential to undermine the macro-solutions of painstakingly constructed global norms and institutions.

Focussing on legal work means we can not only try to understand the macro through the micro, but to elide analysis of both commercial deals and regulation, and as I suggested in the opening paragraph, to draw out the implications of one for

[1]See for example R. Goode, "Reflections on the Harmonisation of Commercial Law" (1991) 1 Uniform Law Review 54 [Goode]; See also M. J. Bonell (1992) "Unification of Law by Non-Legislative Means: the UNIDROIT Draft Principles for International Commercial Contracts" 40(3) The American Journal of Comparative Law 617.

[2]See for example, V. Gessner, and A. C. Budak eds., *Emerging Legal Certainty: Empirical Studies on the Globalization of Law* (Dartmouth, 1998) [*Gessner* and *Budak*].

[3]G. Teubner ed., *Global Law Without a State* (Dartmouth, 1997) [Teubner].

[4]J. Flood, and E. Skordaki, "Normative Bricolage: Informal Rule-making by Accountants and Lawyers in Mega-insolvencies", G. Teubner ed., *Global Law Without a State* (Dartmouth, 1997) [Flood and Skordaki]. Flood and Skordaki analyse the role of lawyers and others in a specific case, but with an interest in the collective creation of norms to deal with a cross-border dispute rather than the construction of a cross-border transaction in the first place.

the other. Socio-legal research on business has looked at contract law in practice and it has looked at regulatory law in practice, but generally as distinct concerns. In the construction of transactions, however, regulatory and private law are intertwined. Focussing on legal work shows how private law in action affects regulatory law in action and vice versa. Both in terms of solving problems and in terms of creating them, the workings of transnational regulation and the workings of transnational commerce cannot be properly understood in isolation from each other, or from legal work.

This chapter, then, turns the spotlight on the legal construction of global deals, on transnational transaction work. It looks at problems and problem-solving in the context of global business and the law. But it approaches "problems" not from a policy perspective but from the pragmatic perspective of practising lawyers working for specific clients, and it analyses problem-solving at a micro rather than a macro level. It focuses not on how the problems posed for business by the current state of law in a global economy *should* be resolved in normative or institutional terms in the future, but on how they *are* being resolved in practice now. In this analysis, however, lie some lessons for policy and for the future. For it not only shows how legal work can solve problems; it demonstrates how solving problems for some can create problems for others. It suggests that law in a global society – whether commercial or regulatory – may face more endemic problems than the challenges involved in constructing uniform norms and enforcing them.

18.2 Business, Law and Competitive Advantage

The problems posed for global business by the lack of global law are generally presented, in terms of the substance of law, as:

- Clashes between jurisdictions, in terms of basic legal concepts, as well as their interpretation and application.
- Multiple requirements being imposed. The classic example is the range of different accounting rules to be met if a company wants to be listed on different stock exchanges.
- Gaps, where there are emergent markets, for example, but no legal infrastructure within them appropriate to market dealing.

These are also seen as leading more generally to uncertainty, and uncertainty is underscored by concerns over cross-border enforcement.[5]

Variability in substance has been addressed by numerous strategies of harmonisation. This may be by way of international treaties between states such as the Vienna Convention on the International Sale of Goods, or by the more ambitious harmonisation of domestic law envisaged by the European Union based on the

[5] *Gessner* and *Budak* (n 2).

inter-state Treaty of Rome. It may be by way of the work of international organizations such as UNCITRAL or UNIDROIT. It may be addressed by judges, lawyers, and accountants working together in specific cases to create special hybrid rules for cross-border contexts.[6] Or it may be initiated by business associations such as International Chambers of Commerce.[7]

The role of business associations themselves has led to the view that global law or pseudo-law is being constructed by business for business as a new lex mercatoria.[8] Business has also been active in setting up its own institutions for international arbitration to deal with disputes.[9] Business can therefore be seen in this sense to be solving its own problems, finding ways to unify the patchwork of varying national laws that obstruct its global deals, via collective action at the macro level, at the level of shared structures.

This is a macro perspective however. At the micro level, business is also doing it for itself, but by individual rather than collective means, and with a more immediate pragmatic and individual business agenda in mind.

Businesses are responding to the "global problem" through transactional legal work by their legal advisers. If a desirable cross-border deal is being obstructed by clashing or inadequate laws or enforcement structures, these are no longer policy problems to be solved by negotiating agreed structures for the future but practical problems which management expects its lawyers to solve now. And solving them is exactly what its lawyers do. Indeed solving obstructive legal problems is exactly what legal work – at its most sophisticated level – is all about.

These are however, individual solutions for individual clients and individual transactions. Often these solutions disseminate to become standard practice. Lex mercatoria is constructed from below, bottom-up from the legal work done to solve problems for individual clients, as well as top-down through standard-setting bodies. Nonetheless they are solutions that originated in private legal work for private clients, through "the pragmatic practices of legal entrepreneurs serving their clients' interests", as I put it many years ago in setting out the concept of law in practice as a "raw material to be worked upon".[10]

It should scarcely come as a surprise to find that businesses (and lawyers) operate at the individual as well as the collective level in addressing global problems. Not only do they have to resolve problems in the here and now in order to pursue global business pending future collective developments, but their

[6]Flood and Skordaki (n 4).

[7]Goode (n 1).

[8]See for example, H. Mertens, "*Lex Mercatoria*: A Self-applying System Beyond National Law?", G. Teubner ed., *Global Law Without a State* (Dartmouth, 1997); See also R. Banakar, "Reflexive Legitimacy in International Arbitration", Gessner and Budak eds., *Emerging Legal Certainty: Empirical Studies on the Globalization of Law* (Dartmouth, 1998) [Banakar].

[9]Y. Dezalay, and B. G. Garth, *Dealing in Virtue: International Commercial Arbitration and the Internationalization of Legal Practice* (University of Chicago Press, 1996); Banakar ibid.

[10]D. McBarnet, "Law and Capital" (1984) 12(3) International Journal of the Sociology of Law 233 [McBarnet, "Law and Capital"].

role in relation to other businesses is not essentially one of collective action. Businesses may have common interests in working together to solve common problems, but they are also in competition. Associates in a sector are also rivals, bent on finding competitive advantage vis-à-vis each other.

Uniformity has the advantages of simplicity and of fostering a sense of certainty and enforceability, and even individual creative solutions can benefit from a wider use that legitimises them.[11] But from a competitive perspective uniformity is a disadvantage. Discussions of global business and the law are often framed in terms of a level playing field. In fact a level playing field is a mixed blessing. From the perspective of any given business a level playing field is exactly what is wanted – for its competitors. For itself it would prefer to find a nice little molehill of competitive advantage rising above it.[12]

Legal work is one means of securing such competitive advantage. Law is not just an obstacle to business but a material which can be worked on to its advantage. If creative means can be found to overcome legal obstructions to global deals then those obstructions – still in existence, at least for a time, for others – become not an obstruction but an opportunity, and a route to competitive advantage. There is therefore a constant drive for new legal constructs to solve the global problem not just at a collective level but at the level of the individual business, the individual deal. That background should be borne in mind as we go on to look in some detail at one example of legal work in a global economy.

18.3 Global Legal Work in Action

The role of legal work in a global economy can best be illustrated through a case study drawn from ongoing research.[13] This particular example concerns the legal construction of cross-border investment in emergent markets, and focuses specifically on a series of deals set up in the late 1990s to initiate foreign investment via international capital markets in a major company in the Russian Federation. The

[11]See T. Frankel, "Cross-border securitization: without law, but not lawless" (1998) 8(2) Duke Journal of Comparative and International Law 255 [Frankel] for an interesting elaboration of this.

[12]For examples in the context of the Single European Market, see D. McBarnet, and C. Whelan, "International Corporate Finance and the Challenge of Creative Compliance", S. Wheeler ed., *The Law of the Business Enterprise* (Oxford University Press, 1994).

[13]The project as a whole draws on data on legal transaction work collected in the course of research conducted over several years in the areas of tax, corporate and banking law and practice (all of which inevitably involved transnational deals), along with new work on the specific issue of transnational transactions. The research has involved documentary analysis, including analysis of contracts and transaction structures, participant observation and especially in-depth technical interviews with individuals from major international law firms, international accounting firms, senior in-house legal counsel for multinational corporations, barristers, bankers, regulators and government agencies. Funding sources include the ESRC, the Jacob Burns Foundation and the European Commission.

analysis that follows presupposes no knowledge of Russian law or international finance, but simply an interest on the part of readers in how lawyers work for clients, and work *with* law, in the context of a global economy. The focus, in short, is on the perceptions and legal accomplishments of transnational actors – and particularly international law firms. What I want to do here is look at some of the problems, posed by Russian law for cross-border investment – as perceived by the international firms acting as intermediaries and advisers in these deals – and how they were resolved by legal work, specifically by the legal work of the international law firm acting for the Russian company.

18.3.1 Cross-Border Legal Risk

The Russian Federation example was chosen in particular to explore the issue of jurisdictional variability, as a result of the absence of global law, and especially the resulting issues of "gaps" in law, and legal clashes. Finance now works via global markets, and societies such as the Russian Federation are seen as new openings for financial markets. They are however, "emergent" markets, and one of the reasons they are "emergent" rather than emerged, is the fact that they are developing from a different social, political and economic context. Their legal infrastructures are likewise "emergent". They are not yet seen by global market players as providing the legal requisites of a market economy. Even where legal provisions have been made there may be concern about their reliability in practice. In short, the economic opportunity for cross-border dealing is there, but there are deemed to be "gaps" in the legal framework.

At the macro level the question is: how should an appropriate legal infrastructure be created to facilitate investment in emergent markets? How can capitalist legal structures be effectively transplanted? The focus is on development, on changing the legal structures of emergent markets as quickly as possible (though that is fraught with difficulties). At the micro level however, the question is different. The question here is how *do* transition economies attract investors who are seeking reasonable legal security in a legal infrastructure that does not, in their view, provide it? How *is* global finance, cross-border investment, functioning in such circumstances? The fact is that foreign investment in transition economies does take place on a large scale. Partly this is because investors entering such markets are willing to take more risk – political and economic as well as legal – because of the potential for very high returns. But it is also because legal risk is mitigated through legal gaps and legal clashes being tackled and overcome by technical legal work.

For any Russian company wanting to attract investment from abroad in the late 1990s (and still), and, in this case, for the US/international law firm advising it, there were two general problems posed by the Russian Federation's legal structure. One problem was posed by the lack of legal protections for investors normally available in western capital markets. The other was posed by the existence of special regulatory obstacles in Russian law which meant conventional instruments

used for cross border investment would not work in the Russian legal context. This is then a classic example of both legal gaps and legal clashes or, indeed, legal barriers, posing problems for cross-border transactions.

These problems were resolved through legal work: partly through spotting problems and negotiating and drafting contractual solutions; and partly through technical transaction work, some routine, some far more complex, tortuous and creative. We'll look first at the more straightforward, at how legal work dealt with regulatory gaps.

18.3.2 Dealing with Regulatory Gaps: Contractual Regulation

The first general problem was the lack of standard Western legal protections for investors in the Russian regulatory structure. As the prospectus for one of the share offerings warned:

> Russia is still in the process of developing the legal framework required by a market economy.[14]

Similar problems pervade the "transition" economies of Eastern Europe in general. In a recent survey conducted in relation to Kazakhstan, 91.6% of respondents saw the legal infrastructure and pace of change in its development as a barrier to trade. Half of those respondents saw this as the major barrier.[15]

In our case study, the strategy adopted was to write in, as contractual obligations, requirements and arrangements normally provided by western regulatory systems, so that what was lacking in Russian regulation was provided for by private agreement. In short private law substituted for what state law had failed to provide; legal work created private or contractual regulation.[16]

This can be illustrated by two examples, two matters judged particularly important for potential investors: the regulatory structures for share registration and financial reporting. The first was basic. It concerned legal recognition of a shareholder's ownership of the shares he or she had purchased. The second is also seen as fundamental to capital markets. It concerned reliable representation of the company's value and prospects to prospective shareholders, and meaningful accountability to shareholders after purchase.

[14]The analysis that follows quotes from some of the documentation studied in detail as part of the research.

[15]Kazakhstan Survey, May 1997.

[16]Teubner (n 3) xiv also observes relationships between the public and the private in the global context, although in his case in the context of norm creation by non-governmental organizations – "private governments" with "a public character".

18.3.2.1 Establishing Ownership: Share Registration

The first problem for the architects of the securities offerings was evidence, and therefore security, of ownership. Under Russian law, ownership of shares in a company was established solely by reference to the company's shareholder register or the records of a depository. The shareholder's rights were therefore entirely dependent on the accuracy of the company's register or the depository's record. Unless the shareholder was recorded on the register he or she would not have any legal basis for claiming ownership of shares in the company. There is an obvious paradox in being totally dependent for legal rights to the profits and assets of a company, on records under the control of the company itself, and one lawyer recounted instances of foreign shareholders simply being struck of the register and so losing the basis of any legal claim to ownership.

At the time of the offerings under analysis, a regulated registration system was just about to come into play. However there were still concerns over how the system would work in practice. For example, I was told that brokers sometimes held shares in their own names, which not only implied continuing risks for the shareholder who is still not registered in person, but which could also produce all kinds of knock-on effects in terms of adverse tax implications.

There were concerns that there was not yet a sufficient infrastructure of independent registrars especially outside the main urban centres such as Moscow and St Petersburg. There was also concern, expressed in the prospectuses, that even with the new rules:

> many Russian companies are unlikely to be in compliance with the share registrar rules

by the due date. What's more, a close look at what is legally allowed even for the "compliant", raises questions about just how independent of companies the new registrars would be. Under the new laws, companies could quite legitimately own up to 20% of the company registering their shares. Indeed our case study company (which had hitherto owned and controlled its registrar) intended to comply with the new rules by joining with several other companies to set up (and each partially own) their new registrar.

Such a situation was unlikely to encourage investors. Measures to address this regulatory situation were therefore incorporated into the contractual arrangements for the offerings. The company undertook as a matter of contractual obligation, to:

> take all and any action as may be necessary to assure the accuracy and completeness of all information set forth in the Share Register.

What is more it agreed to provide the intermediary institutions involved in the deal with "unrestricted access to the Share Register" to check registration "regularly (and in any event not less than monthly)", along with committing to a whole list of specific duties in specific circumstances.

The company was also to be held liable, under the contract, for any failures on the part of the registrar. This might be seen as converting from disadvantage to advantage the scope under even the incoming Russian law for continuing control of

the registrar by the company. The regulatory failings of Russian law, from the perspective of investors, were therefore addressed privately by the introduction of contractual obligations.

18.3.2.2 Information and Accountability: Financial Reporting

In established markets such as the UK or USA, companies are required, as a matter of statutory obligation, to provide public information on their financial status both in terms of their performance and their assets and liabilities. Lawyers advising the Russian company on foreign capital-raising were faced with a different situation under Russian Federation law. As the prospectuses noted:

> While the Securities law contemplates that any company that issues securities to the public will provide periodic reports to the market, regulations implementing this requirement have yet to be adopted. As a result public information about Russian companies is extremely limited

– or more bluntly, as one lawyer put it:

> company accounts in Russia are absolutely useless.

This is of course scarcely surprising since the regulations governing them were drawn up for a completely different economy with completely different criteria of accountability. But the net result is that what is seen by capital markets as appropriate information for assessing risk and reward was simply not required in the Russian legal and regulatory structure at the time of the offering.

However it was required *contractually*. The information given to would-be investors – the offering memorandum – included financial statements drawn up by the company and its subsidiaries not under Russian accounting procedures but under US Generally Accepted Accounting Principles (US GAAP). These were drawn up for the full period of the company's privatisation, resulting in two full annual accounts, and interim half year accounts for the period prior to the share issue. The annual accounts were audited by a "Big 5" international accounting firm under US GAAP rules.[17]

The company also undertook:

> in connection with the Global offering, to publish audited consolidated financial statements in respect of its future financial years . . .and to publish unaudited consolidated half year financial statements in respect of financial periods. . . in each case in accordance with US GAAP.

It undertook, in short, to comply with the standard legal requirements of western capitalist states, specifically, in this case, US federal law. The company does not

[17]Not that this alone guarantees reliable reporting. "Creative accounting" as well as enforcement issues remain a problem even where there are established rules. See I. Griffiths, *Creative Accounting* (Sidgwick and Jackson, 1986) and D. McBarnet, and C. Whelan, *Creative Accounting and the Cross-eyed Javelin Thrower* (Wiley, 1999) [McBarnet and Whelan, *Creative Accounting*].

even make available to its global shareholders, the accounts it prepares under Russian regulations, and the prospectus expressly warns that they:

> should not be relied on by anyone who is unfamiliar with RAR [Regulations on Accounting and Reporting of the Russian Federation] and how they differ from US GAAP.

So US law is transposed into the Russian deal by private legal agreement. It does not merely supplement Russian legal requirements but replaces them completely for the purpose of the global deal.

None of this is very complex technically. Rather it is legal work evidenced in spotting regulatory gaps and filling them by private contractual arrangements, though of course it also involved persuading the Russian company to voluntarily undertake obligations not imposed on it by its own law. This is the more significant when one realises that the state – or at least a vehicle set up to represent it – was itself still the largest shareholder in the company, with a 40% holding of the charter capital, including a "golden share" with special powers. The state had not yet managed to establish an indigenous regulatory framework satisfactory to foreign investors. Nonetheless here it was, under another hat, privately contracting to abide by what was in effect a series of imported foreign regulations.

In a sense it had no choice of course; it wanted foreign investment both in the company and in Russia. The first of this particular set of global offerings was particularly significant. It was to create a marker in the market. There was express reference to this in the prospectus:

> The Global Offering is being conducted in part in order to establish an active international trading market in [the company]'s shares and thus to facilitate access to the international capital markets in the future.

What is more, the hope was that this would open the markets to other Russian companies in the future. This company had to succeed to forge a path for others. There was therefore a strong motivation to do what was necessary to make the deal acceptable in the global capital markets. But it also required effort, a point the lawyer in charge was keen to emphasise, to persuade the company to agree.

It is not the lawyer's power of persuasion that is of particular interest here, however. It is the lawyer's technical skills in problem spotting and problem solving through contract drafting. In particular it is the way contract is used to tackle what are perceived, from a cross border perspective, as regulatory lacunae. The result is legally binding controls constructed through contracts to compensate for regulatory gaps.[18] Legal work creates public law surrogates through private law.

[18]How legally binding *in practice* these are depends, of course, on the efficacy of cross-border enforcement.

18.3.3 Mechanical and Functional Transplants

In the context of law in a global economy, what we see, in effect, is the problem of regulatory variations across borders being overcome in transnational transactions through legal work, either by transplanting, lock stock and barrel, ready made protections from established regulatory regimes abroad, as in the financial reporting example – we could think of this as a *mechanical transplant* – or by transplanting an established regulatory function and satisfying it by constructing functionally equivalent rights, duties and liabilities appropriate to the specific situation, as in the share registration example – we could think of this as a *functional transplant*.

Mechanical transplants may be particularly attractive as a means of transplanting *legitimacy*. Teubner suggests that:

> contractual rule-making . . .is either seen as non-law or as delegated law-making which needs recognition by the official legal order.[19]

But by using rules already recognised by an "official legal order" elsewhere, indeed, by the leading market economy, and recognised in practice in the international capital markets this company – and country – were seeking to enter, the issue of legitimacy may be mitigated. The mechanical transplant of established rules may therefore be a less risky strategy, de facto at least, than the invention of new ones.

Transplanting of legal systems, or elements of them, is often discussed at macro level as a policy for global regulation. But cross-border transplants are also the stuff of cross-border deals, accomplished at micro-level through private law, and through private legal work by lawyers for private clients. Indeed what is being accomplished is a kind of private harmonisation. Private treaties may be accomplishing more readily at the micro level what, at the macro level, is still being striven for through public international law or the work of international organizations.

This is, however, harmonisation with a spin. Indeed it is perhaps more a matter of legal imperialism, with the law of established markets – in this case the USA – transplanted privately into the emergent market.[20] There is, after all, a body of international accounting rules, constructed by the International Accounting Standards Committee (IASC). It was not IASC rules that were written into the contract, however, but US GAAP.

18.3.4 From Substance to Structure: Cross-Border Obstacles and the Passport Deal

Constructing a cross-border transaction, whether with emergent markets or not, usually involves more than just filling legal gaps. It also means dealing with legal

[19]Teubner (n 3) xiii.

[20]See Y. Dezalay, *Marchands de Droit* (Fayard, 1992).

clashes and indeed with legal obstacles to what have, in other jurisdictions, become established as standard legal forms in business practice. Such clashes and obstacles are also overcome through legal work – legal work of a different nature to that discussed in the contractual examples given above. This legal work is concerned less with the substance of the deal than with its underlying structure.

18.3.4.1 Primary and Secondary Transactions: Substance and Structure

The contractual work illustrated above, dealt with the *substance* of the deal – the sale of securities. But underpinning this was a body of deeper transactional work, which dealt with its *structure*. Legal work often involves both what we might think of as the *primary* deal which is the original objective, and a network of *secondary* deals which serve to establish the optimal structure for it.

It is important to distinguish these two levels of legal work. Where socio-legal research refers to commercial law in action it has tended to focus only on what I see as *primary* contracts. But transaction work is about more than primary contracts. The primary contract is, in sophisticated legal work, just the tip of the iceberg, with an often massive, but largely invisible substructure beneath the surface that needs to be researched too. Researching the primary contract alone would oversimplify the nature of the legal work involved in complex cross-border transactions and understate its subtlety, creativity, and technical complexity.

In our case study this deeper structural work was crucial for making the deal work across borders, and in a way deemed commercially, as well as legally viable. Indeed it was this deeper structural work rather than the surface contractual work that earned the transaction its nickname among those constructing it – the "passport deal".

What kind of legal clashes and obstacles were met in the course of constructing these cross-border deals, and how were they resolved? A brief look at one of the underlying structures from our case study may help demonstrate the legal work involved.

18.3.4.2 The Passport Deal

An established instrument used these days for cross-border securities (*now* established – but itself a product of creative legal work in the past) is the Eurobond. One advantage of the Eurobond form is that it does not attract withholding tax. This maximises yield and makes a security sold in this form an attractive option for investors.

Russian law, however, allowed no exceptions to the payment of withholding tax. This meant that the established advantages of the Eurobond structure would not work for Russian shares. This would reduce their attractiveness vis-à-vis other global offerings. The task for advisers, then, was how to construct a structure that

would transfer the advantages of the Eurobond across Russian borders despite the obstacles posed by Russian law.

This was what the construction of the underlying passport deal accomplished. The prospectus for this particular offering could proclaim on its front page:

> Payments on the Notes will be made without deduction for or on account of taxes of Ireland or the Russian Federation.

How does Ireland suddenly come into the picture? In fact not just Ireland but Luxembourg and Germany – or at least corporate structures and financial institutions in them – became involved in the underlying structure that was finally devised to provide a "passport" for what in business terms would be seen as a tax-efficient and therefore commercially viable offering.

In the course of construction other obstacles were met in Russian law. One solution to the withholding tax barrier, involving loans and interest payments between the company and a specially set up foreign subsidiary, which would have worked in other cross-border contexts, would not work in Russia because of its particular rules on Value Added Tax, charged (at 25%) on inter-corporate loans. Another barrier concerned Russian rules erected to protect the country from flight of capital abroad. Russian companies wishing to set up an offshore subsidiary company to hold finance abroad could do so only with the permission of the Central Bank.

The solution finally settled on to overcome these barriers involved interpolating a series of legal relationships between the Russian company and its potential investors, involving an Irish subsidiary along with a German bank and its Luxembourg subsidiary.

The role of the Irish company was to issue the securities, Ireland being chosen for its particular tax advantages. The money would not stay in the foreign subsidiary, however, but come back into the Russian company. How would it come back in without attracting tax? Here the foreign bank became important. A German bank would (though only indirectly as we shall see) receive the money paid for the securities and pay it on to the Russian company. This would be paid to the Russian company, however, in the form of a commercial loan. As such it would attract neither withholding tax nor, since it was a bank loan as opposed to a loan between parent company and subsidiary, would it attract VAT.

Finally, as noted above, the securities were issued from Ireland because of tax advantages. However these particular tax advantages were available only under particular conditions, including the purchase of assets on the secondary markets. Introducing the extra step of the Luxembourg subsidiary between the German bank and the Irish company effectively created a secondary market and so allowed these conditions to be met.

The whole structure involved a network of guarantees, pledges of indebtedness on two levels of priority, certificates of indebtedness, and of course the aforementioned loan agreement, each of these also transnational, between Russian company, Irish company, UK, US German and Austrian underwriters, German bank, and its Luxembourg subsidiary.

On the face of it then we have a sale of Russian securities to, primarily, US and UK investors, and this primary deal incorporates a number of contractual safeguards, the product of legal work, to provide safeguards that the law of the transitional society does not yet provide for itself. This contractual legal work fills gaps.

There is also, however, an invisible substructure of secondary deals underlying this primary deal. This too is the product of legal work, highly creative legal work, and itself of a transnational character. The main task of this structural legal work is to overcome barriers posed to a transnational deal by differences in national legal structures. Under the particularities of Russian law the offering, even with the introduction of contractual safeguards, would not have been attractive. Contractual legal work would have helped temper the legal risks, but to the business world, the impact of Russian-specific tax would have made the deal insufficiently rewarding vis-à-vis other offerings where no tax was involved. The offering would, in short, not have been competing on a level playing field in the global market.

The job of structural legal work was to find a way to make the deal commercially viable through legal means. In this case that meant finding a way to replicate the advantages of a Eurobond type form across borders despite domestic laws that at first sight made this impossible. From the business perspective, its job was to level the playing field for the Russian offering and allow it to participate in the global market.

That these transnational deals were made both legally and commercially viable in a global market was therefore the product of active legal work at both primary contractual and structural levels, legal work which was often highly technical, complex and creative, and which itself involved a further network of secondary multi-transnational deals in support of the primary cross-border contract.

18.4 Implications: Legal Work, Cross-Border Commerce and Global Regulation

What does all this mean for the global law enterprise? Does it mean there is no need for global norms and institutions to facilitate cross-border commerce, since legal work can do the job without it? If shared global law is being accomplished, a level playing field established, from the ground up through practice, is there such a pressing need to establish it from the top down through international agreements on policy?

18.4.1 Cross-Border Commerce, Harmonisation and the Role of Lawyers

In fact there will still be a drive at institutional level towards uniformity. There is value in standardised mechanisms, and tailor made legal work of the kind described

here is expensive – although, of course what begin as tailor-made mechanisms tend to percolate to become standard practice.[21] Legal work, as noted earlier, contributes to a growing lex mercatoria.

That said, business has a complex attitude to harmonised law. Although there is a standard rhetoric among businesses complaining about variations between legal regimes, and calling for harmonisation, in practice variation between regimes is routinely exploited by business to its own advantage. This occurs at the level of politics, in negotiations over what kind of legal regime will be acceptable to multinationals operating under it, with one regime being played off against another. It occurs too in private legal constructions designed to take full advantage of cross-border variations in a sort of regulatory arbitrage. Complex global legal transactions are often only comprehensible if they are seen as artificial constructs designed specifically to take advantage of gaps and clashes between jurisdictions. In short far from the lack of a harmonised global law posing a problem for business, it can also provide an opportunity that routinely is exploited. Business, in other words, can find advantage in both uniformity and conflict between regimes.

In the context of legal creativity, advantage can also be found in different ways, with different consequences for harmonisation. In a world in which business is hampered by cross border gaps and clashes, it may be in the interests of business to use legal creativity to overcome them. Indeed in a context in which competitors remain hampered by gaps and clashes this can produce competitive advantage. A consequence may be a levelling of the international playing field, both for the transaction in hand and, if the practice disseminates, more generally. But that is not the essence of the practice nor its purpose. Creative legal practice is not about harmonisation but about innovation, and the purpose is simply to optimise client interests. Any resulting levelling of the playing field for others is purely incidental. Indeed once such levelling occurs, that particular source of competitive advantage through legal creativity is gone. Business needs to find its "nice little molehill of competitive advantage" some other way.

Legal creativity in pursuit of business interest and competitive advantage is, in fact, much more likely to pose problems for harmonisation than to solve them, precisely because it is continually producing new instruments and practices. As these emerge, so do new challenges for any harmonised law. New forms need decisions on how they are to be treated in law, with the danger of a new patchwork of varying treatments emerging, whether from national legislation, courts or simply the informal decisions of those applying or enforcing the law, until, and unless international consensus on treatment can be accomplished. Creative legal work, in short, can lead to a perpetual dynamic with harmonised law constantly lagging behind. In the Single European market, many years of labour went into trying to produce a level of harmonisation of corporate financial reporting. But the (much compromised) "consensus" was no sooner achieved than it was outdated by the

[21]McBarnet, "Law and Capital" (n 10); M. Powell, "Professional Innovation: Corporate Lawyers and Private Lawmaking" (1993) 18(3) Journal of Law and Social Inquiry 423; Frankel (n 11).

development, and escalation in use, of derivatives and other new financial instruments, on which there was no agreed treatment.[22]

In short, in a business context in which competitive advantage can be gained from legal creativity, legal harmonisation is likely to be constantly chasing legal innovation.

This must make us think carefully about the role of lawyers and legal work in a global economy. Gessner has argued that "legal certainty cannot be achieved globally at the level of programmes" – my macro level of global norms. Rather, he pins his faith in "roles" – and so in the shared expectations generated by networks of arbitrators, business communities, and international lawyers.[23] But the role of lawyers can also be, indeed in its essence *is,* less consensual and collective. Focussing on transnational transactions underlines the more fundamental role of corporate lawyers – working in the interests of clients, often through creative legal engineering. In their role as creative legal engineers, lawyers should be seen as not only having the potential to contribute to harmonisation, but as having the potential to constantly challenge and undermine it.

18.4.2 Legal Work and Transnational Regulation

Harmonisation is one issue, the effectiveness of transnational regulation, another. And for many the regulation of transnational business is the real concern, with harmonisation merely a potential means to that end. Micro-analysis of cross border deal-making has implications for this concern too.

I have shown how creative legal work can overcome legal barriers to cross-border deals and create a level playing field, which may seem a benign enough accomplishment. What are "barriers" from the outside are, however, "policies" from the inside of the country. They are there for a purpose. They are there to regulate business or to raise tax, and creative legal work undermines those policy purposes.

In the Russian example these policy purposes can be seen as rather more complex than this comment may imply. Indeed the creative legal work involved could be seen as avoiding Russian law in order to facilitate Russian governmental policy, since it made possible a deal which the Russian government very much wanted to succeed. It was seen as a key step in facilitating the entry of Russian companies into global markets, and in bringing into the country much needed foreign investment. Nonetheless there is a certain irony in the situation. The Federation of Russia was the dominant shareholder in the company in question. Under one hat, then, it stood for the laws of the land, under another it was not only

[22]From research by D. McBarnet, and C. Whelan.

[23]*Gessner* and *Budak* (n 2) 438; See also Banakar (n 8) 382.

agreeing to US laws overriding its own, but was party to a deal carefully designed to avoid Russian laws.

The point should be considered more generally however. Creative legal work can undermine or quite simply defeat legal control. This is not a trait confined to cross-border legal work but to legal work more generally. Elsewhere my own work or work with colleagues has demonstrated how creative legal structuring of deals can facilitate the circumvention and avoidance of regulatory law of all sorts with knock on effects for those intended to be protected by it.[24] In short there is a sting in the tail of creative legal work. Legal work involves overcoming legal obstacles, and those obstacles are very often regulations intended to protect others.

This has implications for those concerned not just with the facilitation of global business but with its control. One long term concern in globalisation has been the ever increasing power of multi-national corporations and the issue of how to establish effective global regulation of their practices. Since it is recognised that companies currently take advantage of countries with weaker regulations, hope is vested in enhancing and harmonising regulations – and their enforcement – at global level. But this ignores the potential impact of creative legal work.

Creative legal work is not just about playing with the different laws of different jurisdictions, finding tax – or regulatory – havens, set up precisely for that purpose. It is about playing with law per se, even within one jurisdiction. It is about constructing "creative compliance",[25] finding legal forms which fall outside disadvantageous or inside advantageous legal categories. It is about scrutinising legal definitions and thresholds, and repackaging deals to fall within or beyond them – in form though not in substance – as suits. It is about concocting legal forms as yet undreamt of by legislators and regulators. Creative compliance, the product of creative legal work, is likely to remain a problem for regulation even under harmonised and well enforced global laws. What is more, since creative compliance so often depends on legal work at the "invisible" substructural level, its occurrence may not be readily detected.

18.5 Conclusion

So what does a focus on legal work suggest for those concerned with transnational commerce and for those concerned with transnational regulation?

[24]McBarnet, "Law, Policy, and Legal Avoidance: Can Law Effectively Implement Egalitarian Policies?" (1988) 15(1) Journal of Law and Society 113; D. McBarnet, and C. Whelan, "Creative Compliance and the Defeat of Legal Control: The Magic of the Orphan Subsidiary", K. Hawkins ed., *The Human Face of Law* (Oxford University Press, 1997) [McBarnet and Whelan, "Creative Compliance"].

[25]D. McBarnet, and C. Whelan, "The Elusive Spirit of the Law: Formalism and the Struggle for Legal Control" (1991) 54(6) The Modern Law Review 848; McBarnet and Whelan, "Creative Compliance" Ibid; McBarnet and Whelan, *Creative Accounting* (n 17).

For those concerned with the problems of legal gaps and clashes obstructing cross-border commerce, the immediate message of our case study may be encouraging, since it demonstrates that private legal work by lawyers for business can overcome such problems. It can accomplish a kind of harmonisation in practice from below.

However that is not the goal of, or driving force behind, legal work. At macro level, lawyers and law firms, like businesses, may be working for harmonisation in policy, and it is true the dissemination of their legal work techniques creates a kind of harmonisation in practice – in time and temporarily. But at the micro level of private legal work, the driving force is not collective policy. The goal is merely to serve the interests of the individual private client and to find or innovate legal ways to accomplish that. Though legal creativity can, in the current context, be a force for harmonisation, the driving force of innovation for competitive advantage is more likely overall to frustrate harmonisation than to promote it.

What is more, the driving force of clients' interests means legal work is not concerned to promote effective control but all too often is concerned to undermine it. So for those concerned with the *global regulation* of business through law or law-like structures, the message is far from encouraging. Work at macro level to construct global norms and institutions may face problems – not always readily discerned – at the micro-level of practice. Efforts at global control of business may be set up at macro level, only to be destroyed by stealth through routine private legal work.

Part III
Responses To Legal Strategies

Chapter 19
Limits to Horizontal Strategies: Majority Shareholders Facing Minority Activism

Edward I. Hyslop

Abstract This chapter examines the difficulties in finding an appropriate response to strategies. Specifically, this chapter examines the concept of abuse by minority and the way in which a Civil law system might respond to offensive minority strategies.

19.1 Introduction

This chapter first considers the necessity of protecting minority shareholders from majority shareholders and the different rights that might be granted to them for this purpose. The chapter then considers the paradoxical effect of such protections – the protections granted can be turned into legal resources for the creation of aggressive minority strategies.

Having set the stage for discussion, the chapter delves into an examination of the ability of majority shareholders to rely on the concept of abuse of rights by minority shareholders when faced with minority shareholder legal strategies. In order to understand how an abuse of rights by a minority shareholder might manifest itself, this chapter also briefly considers what constitutes abuse by majority as a point of comparison for examining the adoption of similar behaviour by minority shareholders.

19.2 Limits to Majority Strategies

The corporation, in and of itself, constitutes one of the most basic forms of legal strategy, being so common that it tends to be forgotten. Indeed, through the use of the corporate veil, entrepreneurs are often able to escape liability.

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However, a corporation is also a place wherein strategies occur. For example, majority shareholders can be tempted to use their voting rights to dilute the minority shareholders or expropriate them by giving up to a friendly company, the essential assets of the company.

Consequently, to protect minority shareholders, the law establishes certain limits to majority rights. Such limits can be approached either objectively or subjectively: objectively when they are considered from the perspective of a reasonable person, subjectively when they are considered in terms of the effects of an act or decision.

19.2.1 Objective Limits to Majority Strategy

As with most legal systems, Luxembourg law has conferred certain rights on minority shareholders. For example, no decision that increases the commitments of shareholders or changes the nationality of the company can be made without shareholder unanimity.[1] Certain qualified majorities are also required for changes to certain articles (considered in more detail below).[2]

Shareholders also have rights with respect to the adjournment of the general meeting of shareholders. If one-fifth of the shareholders so request, the board of directors – or management board as applicable – must adjourn the general meeting for four weeks.[3] Any such adjournment will cancel any resolution previously passed. The law also provides that at least one general meeting of the company be held each year on a day and time indicated in the articles.[4] Moreover, the directors of the company are obliged to hold a meeting if shareholders representing one-tenth of the corporate capital of the company provide a written request with an indication of the agenda.[5] In the event that such a meeting is not held within one month, then a judge, on application of the shareholders holding one-tenth of the corporate capital, may instruct an agent to convene a meeting.[6] A judge also has similar powers, in exceptional circumstances, to appoint one or more auditors to examine the books and the accounts of the company on the application of one-fifth of the shareholders.[7] Further, as far as mergers by absorption are concerned, approval by an absorbing company is not required if no shareholders representing a minimum of 5% of the corporate capital of this company have requested a general meeting to approve the same. Shareholders can hold such a meeting up to one day

[1] *Companies Act 1915* as amended, Arts. 67-1(1) [*Companies Act 1915*].

[2] See ibid Arts. 67-1(2) and Art. 199.

[3] Ibid Art. 67(5).

[4] Ibid Art. 70.

[5] Ibid para. 2.

[6] See Cour d'Appel, 26 Oct. 1999, role numbers 23801and 23303, comment by F. Fayot in Ann. Dr. Lux. (2001) 553.

[7] *Companies Act 1915* (n 1) Art. 154.

following the holding of the general meeting of the company being acquired to approve the merger. Any such meeting, if requested, must be held within one month of the request.[8]

At a European level and prior to the *19 May 2006 Law on Takeover Bids Implementing European Directive 2004/25/EC of the European Parliament and Council* (the *Public Offer Act 2006*),[9] there was no law related to the protection of minority shareholders in public companies. The *Public Offer Act 2006* only regulates companies quoted on a regulated market within the European Union (EU) terms. The Act states *inter alia* that where a person following an acquisition obtains, directly or indirectly, the control of the company, they are obliged to make an offer at an "equitable price"[10] to protect the minority shareholders in this company.[11] Under certain circumstances, the Luxembourg financial regulator – the Commission de surveillance du secteur financier (CSSF) – may adjust this price.[12] Such a person is however under no obligation to make an offer where control was obtained following an initial offer made to all shareholders for all their shareholdings.[13] Moreover, it is one of the fundamental principles of this law that all shareholders belonging to the same category of shares benefit from an "equal" or "equivalent" treatment.[14]

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[8]Ibid Art. 264.

[9]Law of 19 May 2006 on the Implementation of the European Directive 2004/25/EC of the European Parliament and of the Council of April 21 2004 on Takeover Bids, online: CSSF, Lois et Règlements http://www.cssf.lu/index.php?id=22&L=0&tx_ttnews[cat]=34&cHash=cfbb56faba, and in English: CSSF, Laws and Regulations http://www.cssf.lu/index.php?id=22&L=1&tx_ttnews%5Bcat%5D=34&cHash=cfbb56faba [*Public Offer Act 2006*].

[10]See ibid Art. 5(1) with equitable price as defined by Art 5(4).

[11]Ibid Art. 5(1).

[12]Ibid Art. 5(4); The *Commission de surveillance du secteur financier* is commonly referred to as the CSSF. The CSSF is roughly equivalent to the Financial Services Authority in the United Kingdom (UK).

[13]*Public Offer Act 2006* (n 9) Art. 5.

[14]Ibid Art. 3: "Traitement equivalent"; The question of equal treatment for private shareholders in this manner remains an open one. The issue was brought to a head in the *Bertelsmann* case where Groupe Bruxelles Lambert (GBL) transferred its 30% holding in RTL Group to Bertelsmann in exchange for a holding in Bertelsmann of 25.1%. This transaction gave Bertelsmann a 67% holding in RTL. The minority shareholders in RTL argued that they should have received a similar offer to that of GBL and brought the case before the Luxembourg courts. The last judgment of the Luxembourg Cour d'Appel concluded that "equality of treatment of shareholders is not a general principle of law". See *Bertelsmann* case, Cour d'appel, 12 July 2006, Arrêt commercial, role numbers 28403 and 29202. The Luxembourg Cour de Cassation has since referred this case to the European Court of Justice (ECJ) asking the questions (based on certain European Directives) whether there exists a general community law principle of equality of shareholders and, if so, does such a principle apply only to relations between a company and its shareholders or to relations between the majority shareholders – who are exercising or who are acquiring control of a company – and the minority shareholders of the company. It is also interesting to note here that the question was also asked whether this principle of community law already existed prior to the transposition of the *Public Offer Act 2006* (n 9) into Luxembourg law, and, would such a principle have been applicable to the facts of the *Bertelsmann* case.

The legal obligations and specific rights conferred upon minority shareholders, as briefly described above, constitute strong limits to attempts by majority shareholders to wrong minority shareholders. However, it must be noted that these instruments only frame the power of majority shareholders. They do not take into consideration how shareholders' rights might be used for purposes different from those for which they have been granted. Thus in order to prevent the misuse of rights by majority shareholders, other mechanisms must be utilised.

19.2.2 The Prohibition of Abuse by Majority Shareholders

Aside from the protections conferred upon them by certain provisions, in most Civil law countries, minority shareholders are able to call upon the tort of abuse of majority.

Recent case-law holds that there is an abuse by majority shareholders[15] against minority shareholders when majority shareholders adopt a decision that is contrary to the corporate interest with the sole aim of favouring the majority shareholders to the detriment of minority shareholders.[16] Indeed, shareholders cannot breach fundamental rules of company law, disregard the principle of equal treatment of shareholders, breach the articles or adopt decisions that are not in the interests of the company. In order to demonstrate abuse, however, it is likely also necessary to show that the decision was made in bad faith.[17] That being said, it is submitted that where a decision was adopted contrary to the corporate interest with the sole aim of favouring majority shareholders to the detriment of minority shareholders, it should be fairly easy to demonstrate bad faith.

Any action founded on the basis of abuse by the majority could result in a quashing of a decision adopted by the majority, a finding of damages for the plaintiff or in exceptional circumstances, nomination of a temporary administrator combined with any of the foregoing.[18]

What kind of majority shareholder behaviour then, will establish grounds for an abuse action? Steichen provides the example of systematically putting profits into a legal reserve, for example, on a year-to-year basis.[19] This activity in itself is not an

[15]Also known as *abus de majorité*. The more literal translation "abuse by majority" is chosen here rather than the notion of "oppression by majority".

[16]See *Trib. Arr. Luxembourg*, R. No. 319/89 (13 Oct 1989). There is Belgian authority that holds that an abuse of a majority implies (*implique*) that a decision was taken manifestly and intentionally against the corporate interest favouring the majority shareholders. It was held in this case that, in the context of a group of companies, it was not necessary that majority shareholders themselves benefitted thereby. It was enough that controlling companies benefited. See Cour d'appel de Bruxelles (9 Oct 1984) *Revue pratique des sociétés* (1986) No. 6371.

[17]A. Steichen, *Précis de droit des sociétés*, 1st ed. (Éditions Saint Paul, 2006) 317 [Steichen].

[18]Ibid.

[19]Ibid.

abuse by majority as majority shareholders are not receiving any distributions nor are the minority shareholders. However, might it be considered an abuse if the company has ample cash but continues to transfer more cash to reserves year after year? The answer to this ultimately depends on the circumstances of the case but *prima facie* it is arguable that it is not. First, the question must be asked: in what way have the majority shareholders acted against corporate interest? The plain answer is that they have not. Rather, they have simply not paid themselves or anyone else for that matter, dividends or other cash distribution. The company has thereby not suffered, and on the contrary, it can be seen to have benefited. The majority shareholders may indeed have acted against their own interests, but this of course, is not the same thing as acting against the corporate interest. Accordingly, in this situation, the majority shareholders do not appear to have acted against the corporate interest with the sole aim of benefiting themselves to the detriment of the minority shareholders, or, if they have, it would be quite difficult to prove such an intention on the basis of these actions alone. Perhaps more straightforward examples of abusive majority behaviour are situations where the majority shareholders pay themselves excessive salaries for a given year or where there are abuses of the articles of association of the company in such a way as to ultimately result in the exclusion of the minority shareholders from the management of the company.

19.3 Understanding Minority Strategies

The existence of mechanisms for the protection of minority shareholders produces a paradoxical effect. Indeed, the specific voting requirements concerning certain decisions, like those concerning mergers for example, facilitate the adoption of legal strategies by minority shareholders.

In a Civil law legal system such as Luxembourg, assuming that all proper convocation and quorum requirements have been satisfied, company decisions are adopted by a majority of shareholders present at a shareholders' meeting.[20] Shareholders' meetings have wide-ranging powers to either act or refrain from acting or to ratify any act that is in the interests of the company.[21] Consequently shareholders' meetings are the central place where the strategies of different groups of shareholders conflict as some might desire to adopt, block or delay certain decisions to their own advantage. For example, in order to quiet activist shareholders, a firm might go so far as to purchase their shares for more than their value. The hedge fund example is a particularly helpful example in illuminating the many strategies aimed at putting pressure on a firm's board to steer its consequent decisions.

[20]See *Companies Act 1915* (n 1), Art. 67.

[21]Ibid.

19.3.1 The Hedge Fund Example

Although currently there is no widely agreed upon definition of "hedge fund", hedge funds are typically described as unregulated, privately organized investment vehicles, not widely available to the public and administered by professional investment managers.[22] They typically consist of general and limited partners. Hedge fund managers tend to be highly motivated as their own remuneration depends on the success or otherwise of the hedge fund. Professors Brav et al., in their five year study of hedge fund activism between 2001 and 2006, noted that the kinds of firms that tend to be targeted by hedge fund activists are low-growth, highly leveraged, profitable companies with high institutional ownership[23] that the funds consider undervalued or that they think might benefit from a change in corporate governance. For example, when it regards a company as undervalued, a hedge fund might seek to: maximise shareholder value; favour an impeding take over, potential merger, or restructuring of the company; or improve operational efficiency.[24]

In practical terms, hedge fund activism entails a hedge fund buying more stock in a target company and trying to steer management decisions in a particular direction. Frequently, this will involve encouraging an operational policy shift to approve, for example, a merger or take-over. This type of activity helps fulfill the hedge funds' primary aim of making money for investors over the short term. There is some uncertainty though as to whether long term benefits might also be derived from such activism.[25]

Hedge funds do not always hold the majority of shares in the target company and therefore encounter difficulties in imposing their point of view. Consequently, hedge funds seek out ways to increase their voting power, which can include the use of communication and legal strategies.

19.3.2 Communication Strategies

Professors Brav et al. have examined a number of strategies typically employed by hedge funds. According to Brav et al., these strategies include "non-aggressive" strategies such as hedge fund communication with management to enhance

[22]A. Brav, W. Jiang, F. Partnoy, and R. S. Thomas, "The Returns to Hedge Fund Activism" (2008) ECGI – Law Working Paper No. 098/2008 7, online: SSRN http://ssrn.com/abstract=1111778 [Brav, Jiang, Partnoy and Thomas].

[23]Ibid 20–21.

[24]See F. Terré, P. Simler, and Y. Lequette, *Droit Civil: Les Obligations*, 9th ed. (Dalloz, 2005), Table 1, for a full list of hedge funds [Terré, Simler and Lequette].

[25]R. Greenwood, "The Hedge Fund as Activist" (2007) Harvard Business School, Working Knowledge, online: The Hedge Fund http://hbswk.hbs.edu/item/5743.htmlm.

shareholder value and the seeking of management representation. There are also more "aggressive" strategies, for example, strategies that make direct proposals to shareholders or publicly criticise the company and then make demand for change. Additionally, a hedge fund may also threaten to wage a proxy fight, sue the company for breach of duty or launch a contest to replace the board at the company's next annual general meeting. Interestingly, the most popular hedge fund tactic appears to be the non-aggressive communication with management to improve shareholder value with the least popular involving more aggressive intentions like gaining control of a company by way of a takeover bid.[26]

One illustration of shareholder strategy is the strategy connected to the desire of Carl Icahn for a Microsoft take-over of Yahoo![27] Microsoft opened their bidding on Yahoo! shares on 31 January 2008 at US $31 per share[28] which later was increased to US $33 per share.[29] The Yahoo! board, including Yahoo! founders Jerry Yang and David Filo, indicated that it was not willing to settle for Microsoft's latest offer,[30] having predicted that the company would be worth more and forecasting revenue growth of up to 25% in 2009 and 2010.[31] Icahn dismissed such forecasting as "irresponsible" and "unconscionable"[32] and nominated directors more

[26]See Terré, Simler and Lequette (n 24) finding that 48.3% of hedge funds adopt the former tactic with only 4.2% adopting the latter. It is to be noted, however, that 32% of hedge funds made formal shareholder proposals or publically criticised the company and demanded changes.

[27]See press release by C. Icahn, "Icahn Issues Open Letter to Shareholders of Yahoo!" The Icahn Report (14 July 2008), online: Icahn Report http://www.icahnreport.com/report/files/icahn_press_release.pdf.

[28]See "Microsoft bids USD 44.6 billion for Yahoo! (USA)", Wireless Federation, (4 February 2008), online: Wireless News http://wirelessfederation.com/news/microsoft-bids-usd-446-bilion-for-yahoo-usa/.

[29]See letter from Microsoft CEO Steve Ballmer to Yahoo! CEO Jerry Yang in "Microsoft Withdraws Proposal to Acquire Yahoo!" Microsoft, (3 May 2008), online: Microsoft http://www.microsoft.com/presspass/press/2008/may08/05-03letter.mspx.

[30]Ibid.

[31]See M. Liedtke, "Icahn to Yahoo Board: Sell to Microsoft or Leave", USA Today, (16 May 2008), online: Icahn to Yahoo Board http://www.usatoday.com/tech/products/2008-05-15-729493711_x.htm; See also M. Liedtke, "Yahoo Sees Rosy Outlook for 2009, 2010", USA Today, (18 March 2008), online: Yahoo sees rosy outlook http://www.usatoday.com/tech/products/2008-03-18-2207792191_x.htm.

[32]See A. Clark, "Corporate Raider Icahn Leads Investor Revolt Against Yahoo Board" The Guardian, (16 May 2008), online: Corporate raider http://www.guardian.co.uk/business/2008/may/16/yahoo.yahoo; See also M. Liedtke, "Icahn Moves to Bring Yahoo Back to Table with Microsoft", The Seattle Times, (15 May 2008) noting that "Icahn has a long history of challenging corporate boards and his efforts often result in shake-ups. Most recently, he has forced major changes at Blockbuster and Motorola. He also played a pivotal role in the recent $8.5 billion sale of business software maker BEA Systems to rival Oracle, which dropped an earlier bid of $6.7 billion", online: Business & Technology http://seattletimes.nwsource.com/html/businesstechnology/2004416505_webyahoo15.html.

sympathetic to a Microsoft take-over to replace the current board.[33] At the time of writing, supporters of Icahn included oil investor T. Boone Pickens, Third Point, a hedge fund led by activist investor Dan Loeb and New York based hedge fund Paulson & Co.[34] Together they have accumulated more than 5% of Yahoo!, with Icahn having an option to purchase a further 49 million shares in the company. Although Microsoft at the time of writing appeared cool about re-opening negotiations, some commentators speculate that neither Yahoo! nor Microsoft has truly conceded.[35] However, at the annual general meeting of shareholders of Yahoo! held on 1 August 2008, Icahn was a "no show".[36] It would appear that Icahn realised that he would not have been able to garner enough support to obtain majority directorships in Yahoo! He came to a compromise deal with Yahoo! whereby he is to be offered a seat on the board together with two of his nominees, bringing the total number of seats on the board from nine to eleven.[37] It remains to be seen how negotiations between Microsoft and Yahoo! will continue to progress.

19.3.3 Legal Strategies

In addition to strategies based on communications and exploitation of the media, hedge funds also rely on legal mechanisms in order to impose their point of view.[38]

Most of the time, hedge funds will have to negotiate their rights against a counterpart when they have a negative or blocking power within the company. For example, certain decisions within a Luxembourg company call for a qualified majority of shareholders to vote in favour. An example of this is an increase in

[33]See "Icahn Sets Out to Replace 'Irresponsible' Yahoo Board in Move to Renew Microsoft Talks", International Herald Tribune, (15 May 2008), online: Icahn sets out to replace http://www.iht.com/articles/ap/2008/05/15/business/NA-FIN-US-Yahoo-Icahn.php [Icahn Sets Out].

[34]"Icahn Supporters buy Yahoo Shares", BBC News, (21 May 2008), online: BBC news http://news.bbc.co.uk/1/hi/business/7412264.stm.

[35]See ibid and Icahn Sets Out (n 33).

[36]Y-W Yen, "Yahoo's Big Summer Letdown", Fortune, (31 July 2008); See also C. Ichan's explanation, "Concerning the Annual Yahoo! Meeting", The Icahn Report, online: The Icahn Report http://www.icahnreport.com/report/2008/07/concerning-the.html.

[37]See M. Helft, "Yahoo Deal Wards of Proxy Fight", N.Y. Times, (22 July 2008), online: Yahoo Deal http://www.nytimes.com/2008/07/22/technology/22yahoo.html. To summarise the strategy: a well-known minority shareholder takes the initiative to actively criticise a company decision, making other shareholders aware of his belief that the company is undervalued. The activist makes his discontent known in the media and proposes new names for the board.

[38]Other methods might include a hedge fund using their shareholders' rights to launch a fishing expedition whereby all corporate documents that it has access to are requested for the purpose of either getting particular commercial information or uncovering a fraud thus providing the hedge fund with additional means of pressure.

capital in a *société anonyme*.[39] Because it results in a change in the articles of association of the company, the decision must be adopted by at least two-thirds of the votes cast.[40] It can be seen then that a shareholder with a 35% holding could *prima facie* block such an increase in capital. However, the efficiency of such a strategy will vary with the circumstances. Consequently, hedge funds use different techniques to weigh in at the corporate general meeting.

First, hedge funds take recourse to share loans and any other techniques that permit a temporary transfer of voting rights, as seen with, for example, in a sale with an option to repurchase.

Second, hedge funds can try to impose their mandate on other shareholders. In order to convince shareholders, hedge funds do not hesitate in claiming that they already have some power and consequently they end up with significant power, i.e. a self-fulfilling prophesy.

Third, hedge funds can buy shares just prior to the establishment of the list of shareholders able to take part in the general assembly of the shareholders and then sell immediately after. Consequently, hedge funds are able to vote without truly being shareholders and therefore do not have to carry the consequence(s) of their vote.[41]

19.3.4 Possible Defences

In order to prevent minority shareholders from using their rights in such a manner, the Civil law system also provides majority shareholders with a tort for abuse by minority.[42] As with all shareholders, minority shareholders must act in the corporate interest of the company. Simply because minority shareholders do not approve of the way a majority shareholder proposes to act, minority shareholders cannot block the proposed act, for example, out of spite, at least in theory. Rather, minority shareholders are wise to always reflect on what is in the company's interests before acting. This approach, however, must be balanced with the reality of the courts' hesitation in regard to decisions taken by shareholders. That is, courts will not

[39]The société anonyme is a form of limited liability company with a Board of Directors (conseil d'administration) chaired by a PDG (président directeur-general). The share capital is divided into shares and its shareholders are only liable up to the amount of their contributions to the company. For further discussion see Le Gouvernement du Grande-Duché de Luxembourg, *Doing Business in Luxembourg* (2007), online: Doing Business http://www.entreprises.public.lu/publications/other_languages/english/doing_business/.

[40]*Companies Act 1915* (n 1) Art. 67-1(2); The same is true for any change in the articles of association of the company.

[41]One can imagine that a competitor might use such a technique to injure a firm, thus avoiding any expense or consequence.

[42]There are also limits on communication strategies, for example, in the form of actions concerning: business denigration; libel; or manipulation of share price.

lightly substitute shareholder decisions for their own. Indeed, it is often only in extreme cases, such as when the life of the company is threatened, where the courts will intervene.

Minority shareholder abuse cases have arisen under French law. For example, one case held that a refusal to vote for an increase in capital imperative for the survival of the company constituted an *abus de droit* by a minority shareholder.[43] Although a minority shareholder is permitted to make decisions for personal reasons, it is not permitted to act purely on the basis of personal considerations *which have as their sole aim*, the blocking of the good administration of the company.[44]

So how do we ascertain if there has been an *abus de droit*?[45] The common law lawyer might find the idea of *abus de droit* quite perplexing: either one has a right or one does not, hence, one cannot use rights abusively or act within the law abusively

[43]See Cass. Com. (5 May 1998) No. 001942, sté A. Moul c / R. Couvaud, JCP G (1998), IV, 2447 [Cass. Com. (5 May 1998)]. In this case, a company brought an action against the abusive minority shareholder. The company had lost more than half of its capital. The shareholder had refused to vote for the company's dissolution and also refused to vote for an increase in capital. The French Cour de Cassation held that the shareholder was acting out of purely personal considerations – for example because of his removal from the board of directors and because of certain other interests that he held in a competing company – which were solely aimed at the hindering of the proper working of the company. It is interesting to note here that the company requested that the court appoint a third-party to represent the respondent shareholder at the subsequent shareholders' meeting to vote in favour of the increase. This request was granted.

[44]This reality has also been recognised in Luxembourg. Where the survival of the company is at stake, however, courts will be less likely to indulge or regard sympathetically, a minority shareholder who threatens the life of the company with its truculent behaviour. Steichen (n 17) 316, 319–320. Although the concept of abuse by shareholders has been recognised, there is no specific case-law on the subject in Luxembourg, but the remedy provided by the French should likely be followed in Luxembourg: It would be difficult to imagine how minority shareholders could successfully impose their collective will on the majority shareholders as, in general, a majority vote of shareholders is required for all shareholders' decisions. This does not mean, however, that minority shareholders can adopt a strategy deliberately to hinder the good working of the company. If such a minority shareholder acts solely from his own personal interests putting the very life of the company in jeopardy then it is suggested that a Luxembourg court ought to provide a remedy similar to that of France. While maintaining the principle that, in general, Luxembourg judges do not stand in the shoes of the competent bodies that adopt decisions at company level, Steichen notes that it should be possible for a court to determine an agent to represent majority shareholders and to vote in the corporate interest – should the need arise. Note that this does not necessarily mean adopting the position of the majority shareholders de plano. A judge may also perhaps be able to remove the voting power of the relevant minority shareholder who is blocking the proposed project. See Steichen (n 17) 320; See also Cass com, Paris (15 July 1992), JCP ed. No 49, 375.

[45]The idea of *abus de droit* is the central concept in most of the European responses to legal strategy. This concept, *abus de droit*, plays a significant role in a court's determination of whether behaviour has been abusive and therefore potentially acts as a limitation to legal strategies launched by minority shareholders.

as the term *prima facie* might seem to imply. Indeed, some writers acknowledge this exact conundrum.[46] In essence, *abus de droit* involves the right holder using its rights in bad faith or in a way that is forbidden. An example of this is using a right with the sole intention to harm and in such a way that brings no benefit to the holder of the right.[47] With respect to the intention element, there is debate as to whether the finding of the requisite intention should be achieved subjectively or objectively.[48] On one hand, it has been suggested that the search for subjective criteria plays the most prominent role.[49] In this case, there should be either exercise of the right with malicious intention (*intention malicieuse*), i.e. with the sole aim of harming another party or exercise of the right with carelessness, or negligence (*imprudence* or *négligence*). On the other hand, it has also been suggested that what is decisive is whether the act itself is in some way abnormal either in itself or by the result it engenders, regardless of the subjective motive. On either the objective or subjective element of intention however, it can be argued that the minority in the French case briefly described above[50] had committed an *abus de droit* – in that case the shareholder's action blocked the good administration of the company with the sole intention to harm the company.[51]

To compare briefly this limit to legal strategy with those provided by the common law system, we can refer to section 994 of the *Companies Act 2006*[52] of the United Kingdom (UK) which provides a remedy against *unfairly prejudicial* conduct. Under this provision, any member of the company can petition the court on the grounds that the company's affairs are being conducted in a way that is unfairly prejudicial to some or all of the members or that a proposed act or omission of the company would be so prejudicial. Here, the plaintiff must show that the conduct was both unfair and prejudicial. Unfairness is the general idea of acting contrary to good faith while prejudice is the notion of harm in a commercial sense, as opposed to an emotional sense.[53] This test appears to give the British courts a great deal of leeway in determining what is unfairly prejudicial conduct and consequently has gone so far as to include shareholders' legitimate expectations in management decisions[54] including expectations related to: using company assets

[46]See for example, Terré, Simler and Lequette (n 24) 740, quoting M. Planiol, *Traité élémentaire de droit civil*, Ft 3: "La droit cesse là où l'abus commence, car la loi ne peut défendre ce qu'elle permet".

[47]Ibid: "l'intention de nuire".

[48]Ibid 723.

[49]Ibid 741.

[50]Cass. Com. (5 May 1998) (n 43) 31.

[51]Ibid: ". . .la société, avait eu pour seul but d'entraver le fonctionnement de celle-ci. . .".

[52]*Companies Act 2006* (C. 46), online: Companies Act 2006 http://www.opsi.gov.uk/ACTS/acts2006/ukpga_20060046_en_1 [*Companies Act 2006*].

[53]*Re Unisoft Group Ltd* (No. 3) [1994] 1 BCLC 609, 611.

[54]See *Ebrahimi v. Westbourne Galleries Ltd* [1973] AC 360, [1972] 2 All ER 492 (HL).

for the benefit of family and friends;[55] paying excessive remuneration to director shareholders; not distributing dividends where a company has no use for retained profits;[56] and proposing to sell a company's business at a substantial undervaluation to connected persons.[57]

Remedies for *unfairly prejudicial* conduct under the *Companies Act 2006* include: regulating the company's affairs in the future; requiring the company to act or omit from acting in a certain way; and importantly, providing for the purchase of the shares of any members of the company by other members or by the company itself and, in the case of a purchase by the company itself, the reduction of the company's capital accordingly.[58]

Prior to the *unfairly prejudicial* test, a member had to show that the conduct in question was oppressive. This was an arguably more stringent test, being interpreted as behaviour that was "burdensome, harsh and wrongful".[59] Additionally, there was some uncertainty as to whether actual illegality or invasion of legal rights was required. Regardless, the use of the less stringent test of *unfairly prejudicial* has in essence been embodied in statute since 1980.[60] It is submitted that this test along with its remedies as provided under the *Companies Act 2006*, provides more scope to members who feel their interests are threatened without having to go so far as to show – as it would currently appear under Luxembourgish or French law – bad faith or the "contrary to corporate interest with the sole aim of benefiting" test which arguably is more akin to the earlier "oppressive" test of the UK.[61]

19.4 Conclusion

Minority shareholders have interests that require protection, calling for rules to accomplish same – they must be protected from a broad range of majority activities including: exclusion from management; preclusion from selling shares at the best

[55]See *Re Elgindata Ltd.* [1991] BCLC 959.

[56]See *Re a Company* (No. 004415 of 1996) [1997] 1 BCLC 479.

[57]See *Re a Company* (1987) 1 WLR 102.

[58]*Companies Act 2006* (n 52) s. 996.

[59]*Scottish Co-operative Wholesale Society v. Meyer* [1959] AC 324.

[60]See *Companies Act 1980*, s. 175 following the Jenkins Committee on Company Law reporting in 1962.

[61]It now appears that some further relief for shareholders might soon be forthcoming in Luxembourg. The Luxembourg legislature is considering, under Draft Bill 5730, a new remedy for, *inter alios*, shareholders representing at least 1% of the corporate capital of the company where directors can be held liable for any faults they have committed during their tenure. For the time being, until this legislation is passed, a company has only the power to invoke directors' responsibility via the general shareholders' meeting. If this new legislation is passed, it will certainly be an interesting development in Luxembourg law. See *Draft Bill 5730* Art. II (41), online: kckg http://www.kckg.lu/download/news/5730.pdf; The *Draft Bill 5730* under Art. II (41) also proposes the introduction of a certain shares having a "double vote".

price; and the selling of the company's assets at a substantial undervaluation. That being said however, it is also arguable that the legislature ought not to be the vaccination that inoculates against all ills. Indeed, any protective rules conferred upon minority shareholders can be easily turned into a resource for legal strategies. Accordingly, it can be observed that minority shareholders have manipulated certain protections to develop strategies aimed at frustrating the will of majority shareholders, for example, through a negative or "blocking power" or through more vigorous hedge fund interventions.[62]

Consequently, the development of mechanisms of protection for majority shareholders is also necessary. In Europe, the tort of abuse by minority is one such development.

Our intention here is not to criticise the protections granted to minorities or for that matter majority shareholders, but rather to underline the difficulty for regulators or legislators in responding to abusive behaviours, namely, developing a response which does not at the same time open the door to new legal strategies.

Despite this challenge, effective solutions should still be sought. For example, with respect to abuse of rights, first and theoretically speaking, a solution might first be to confine expressly any newly created minority right through the imposition of strict conditions on the exercise of the new right. Second, as shown in the UK, it should be understood that, generally speaking, members should have no legitimate expectations beyond the rights conferred by the constitution of the company which in turn should restrict or limit the grounds for claiming "unfair prejudice" for bad management.[63] After all, investors invest capital, and, accordingly they should be expected to bear all reasonable risks.

Generally, the most effective responses to undesirable legal strategies will be those that are developed cognizant of the circular nature of strategy and response – regulatory responses inspire new legal strategies which in turn call for further regulatory responses which inspire new strategies. Consciously seeking to reduce this circular effect will no doubt require thoughtful and creative approaches and aggressive regulatory/legislative drafting.

[62]Indeed, aggressive strategies are becoming more and more common in the United States and as well as in the UK with UK firms apparently being the most likely target of hedge fund activists in Europe. It is believed that in general, hedge fund strategists have been approximately 60% successful or at least partially successful in their strategies. See ibid and Brav, Jiang, Partnoy and Thomas (n 22). See "Hedge Funds Home in on UK Targets, Survey Finds", The Financial Times, (4 November 2007); But see also some responses to such shareholder activism for example, in "The Conference Board Working Group on Hedge Fund Activism Issues Final Recommendations . . . " (17 September 2008) which among other things recommends that, "For this reason, the Group recommends that companies proactively develop an inventory of those strategic, financial, and governance-related vulnerabilities that could undermine their value and single them out as potential targets to activists".

[63]*Re Elgindata Ltd* [1991] BCLC 959.

As legislation is rarely drafted to cover all situations[64] and notwithstanding the inherent ethical implications and considerations, a firm that aims to implement a legal strategy should always take into consideration existing rules that limit its activities. However, instead of simply perceiving these limitations as risks or constraints a firm might just want to consider how these legal limits can be transformed into legal resources and even opportunities.

[64]See for example, discussion on accuracy in drafting vs. simplicity, in B. Hunt, "Plain Language in Legislative Drafting: Is it Really the Answer?" (2002) 23(1) Statute Law Review 31–36.

Chapter 20
Innovation and Access: Legal Strategies at the Intellectual Property Rights and Competition Law Interface

Daryl Lim

Abstract Innovation is a commercially risky and legally perilous process. It is risky because large sunk costs are often required to initiate and sustain research, product development and other steps involved in the offering of the product and winning of the market. At the cusp of commercial success however, firms have to contend with uncertainty as to whether the manner in which they exploit any intellectual property (IP) rights they have, or may be acquiring, will pass the scrutiny of competition laws. In the wake of a recent Microsoft decision in the European Union and developments elsewhere, companies have had to reassess their corporate strategies, not merely at a local or regional level, but because of the nature of IP exploitation today, on a global scale as well. This paper begins with a reflection on how courts and competition authorities regard various legal strategies implemented in the exploitation of IP rights. The discussion includes an evaluation of the legitimacy of regulatory responses to these strategies as well as the regulatory schism that impacts trans-border IP strategies. The paper then considers how firms can maximise the value of their IP within the present regulatory environment by influencing the normative framework of competition policy. The limits of this influence are explored and the paper concludes with a discussion on how global trends are likely to shape the strategic landscape arising out of the interface between IP and competition law in the years ahead.

20.1 Introduction

In the modern marketplace, corporations increasingly exert calculated influence on their legal environment in order to enhance their competitive advantage. Legal strategy permeates the interface between intellectual property (IP) rights and

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competition law (the "Interface"), just as it does other complex legal landscapes.[1] Indeed, the law may be more malleable at the Interface than in any other such complex landscapes. Strategists thrive in environments where the law is volatile or amorphous because these environments make legal outcomes more susceptible to tactical manoeuvring.[2] The Interface is both volatile *and* amorphous. The goals of competition and IP are not altogether harmonious and the distinction between permissible and prohibited forms of competition bedevils its application,[3] despite the prevailing view in some quarters.[4] The essence of IP is the right to reduce free-riding and secure a favourable return on the owners' investment of time, effort and skill. This exclusionary right, however, is a means to an end. IP has become part of the arsenal of sophisticated legal strategies and is critical to achieving and sustaining a competitive advantage in the marketplace, particularly as more countries depend on science and technology to drive their economies.[5] While the grant and

[1]"Competition policy generally refers to a set of government measures that enhance competition, give primacy to market forces, facilitate entry and exit, reduce administrative controls, and minimize regulations. Competition law refers to a statute to prohibit and penalize anti-competitive practices and regulate potentially anti-competitive mergers." V. Dhall, "Concepts in Competition Law," V. Dhall ed., *Competition Law Today: Concepts, Issues and Law in Practice* (Oxford University Press, 2007) 28 [Dhall].

[2]"The legal strategist manipulates those odds in a game of skill, expanding and developing the array of decisions, issues, and problems in a manner calculated to confuse and ultimately overwhelm the opponent. Even if the 'merits' should ever reach a decision maker, it will be a decision maker identified by the game, and the 'merits' will reach that decision maker in a form determined by the game." L. M. LoPucki, and W. O. Weyrauch, "A Theory of Legal Strategy" (2000) 49(6) Duke Law Journal 1412, an edited reprint in this text at Chap. 4 [LoPucki and Weyrauch].

[3]"Intellectual property law differs from competition law in both its function and its goals. [. . .] In fact, there seems to be an unavoidable source of conflict between the two bodies of Law. While IP rights do not necessarily confer significant monopoly power, they can only be effective if they sometimes do." P. Régibeau, and K. Rockett, "The Relationship Between Intellectual Property Law and Competition Law: An Economic Approach" (2004) University of Essex, Department of Economics, Economics Discussion Papers No. 581, 25, online: The Relationship Between Intellectual Property Law and Competition Law: An Economic Approach http://ideas.repec.org/p/esx/essedp/581.html [Régibeau and Rockett]; "[I]t is important to stress that IP laws and competition law have different policy goals which cannot be easily harmonized with one another. The assertion that both laws are intended to protect consumer welfare seems a bit of a stretch in this sense." E. Arezzo, "Intellectual Property Rights at the Crossroad between Monopolization and Abuse of Dominant Position: American and European Approaches Compared" (2007) 24(3) John Marshall Journal of Computer & Information Law 455, 504, online: SSRN http://papers.ssrn.com/sol3/papers.cfm?abstract_id=935047 [Arezzo].

[4]"Over the past several decades, antitrust enforcers and the courts have come to recognize that intellectual property laws and antitrust laws share the same fundamental goals of enhancing consumer welfare and promoting innovation." United States, Department of Justice and Federal Trade Commission, "Antitrust Enforcement and Intellectual Property Rights: Promoting Innovation and Competition" (2007), online: Federal Trade Commission http://www.ftc.gov/reports/innovation/P040101PromotingInnovationandCompetitionrpt0704.pdf [Promoting Innovation].

[5]"A key part of establishing patent strategy is the recognition of what provides a real competitive advantage, and then attempting to maintain the proprietary nature of that advantage." H. J. Knight,

exercise of IP is usually consistent with promoting innovation and benefiting consumers, IP strategies may run counter to competition laws and attract regulatory retaliation in the form of restraints on the owners' exercise of their rights by competition authorities and courts.[6]

IP markets that attract competition scrutiny often relate to subject matter that lies at the nascent frontiers of protection. Competition policy contends with the trade-off between static efficiency and dynamic efficiency.[7] It allows firms to maximise their profits by weakening or eliminating competitive constraints provided by rivals to the extent justified by their own investment, innovation, industry, or foresight in the production and dissemination of the subject matter of their IP. As the IP system strains to accommodate new subject matter, the trade-off between providing an incentive to invest in innovation and the liberty of others to exploit the protected product has to be constantly redefined. A quintessential example would be fast moving technology markets, the focal point of this discussion. Landmark cases against Microsoft[8] and Rambus[9] have brought complex and contentious issues such as standards and network effects under the Interface's fitful spotlight.[10] Technical

Patent Strategy: For Researchers and Research Managers, (John Wiley & Sons, 1996) 62 [Knight].

[6]The terms "regulatory" and "regulators" are used in the context of competition law enforcement. "This occurs because the commercial strategy chosen to exploit the IPR protected product occasionally gets caught in the crossfire of the measures used by competition policy to maintain competitive markets." S. Anderman, "Microsoft in Europe" (2002) Submission at Hearings on Competition and Intellectual Property Law and Policy in the Knowledge-Based Economy, Feb. 6 – Nov. 6, 2002, before the US Federal Trade Commission 23, online: Microsoft in Europe http://www.ftc.gov/opp/intellect/020522anderman.pdf [Anderman].

[7]Static efficiency occurs when firms compete within an existing technology to streamline their methods, cut costs, and drive the price of a product embodying that technology down to something close to the cost of unit production. Static goals lead to a focus on short-run marginal cost to the exclusion of long run efficient capital investments in research and development. Static efficiency is a powerful force for increasing consumer welfare, but economists tell us that an even greater driver of consumer welfare is dynamic efficiency. Dynamic efficiency refers to gains that result from entirely new ways of doing business. See generally J. A. Schumpeter, *Capitalism, Socialism and Democracy*, 2d ed. (Harper & Brothers Publishers, 1947).

[8]*Microsoft Corp. v. Commission of the European Communities*, [2007] 5 C.M.L.R. 11, Case T-201/04, 2007 WL 2693858, online: The Court of Justice of the European Communities, Curia, Recent Case-Law http://curia.europa.eu/jurisp/cgi-bin/gettext.pl?where=&lang=en&-num=79929082T19040201&doc=T&ouvert=T&seance=ARRET [*Microsoft Corp.*].

[9]*Rambus Inc. v. FTC*, (2008) 522 F.3d 456 (D.C. Cir.) [*Rambus*].

[10]The term "network effect" describes the phenomenon whereby the utility that a consumer obtains from a given good grows proportionally to the number of other consumers using the same product. As more consumers use the innovation, others will desire it. Further, the increase in users causes a consequent boost in the development of compatible products, as other firms will find it profitable to invest in it.; "Liebowitz and Margolis introduced the term 'network effects' to substitute for the term network externalities, to account for the possibility, indeed, the likelihood, these effects are often internalized." P. Lewin, "Introduction: The Market Process and the Economics of QWERTY," P. Lewin ed., *The Economics of QWERTY* (Palgrave, 2002); Literature on network effects is abundant and varied. See for example M. A. Lemley, and D. McGowan, "Legal Implications of Network Economic Effects" (1998) 86 California Law Review 523; See

regulations and standards affect about 80% of international trade,[11] and the economic and technological effects flowing from these cases are considerable.[12]

There is a great deal of quality writing at the Interface dedicated to examining the access–innovation dichotomy, much of it of recent vintage. Yet despite the audible whir of strategic machinations underpinning private and regulatory activity in this area, scant attention has been given to its comprehensive study. The study of legal strategy is crucial to understanding the invisible forces shaping Interface law. The goal of this work is therefore to unravel these machinations and draw strategic analysis from the isolated suburbs of Interface scholarship into its centre, where it surely belongs.

It is the thesis of this paper that it is in the interests of all stakeholders that courts and regulatory bodies establish clear rules, guided by restraint, before using competition laws to interfere with IP strategies. The immediate beneficiaries of such an approach might be dominant IP owners, but regulators will also find that their limited resources can be channelled to areas where regulation yields more immediate and less controversial results. Rivals and customers may appear to be the initial victims, but appearances can deceive. Rivals operate under the same rules as dominant IP owners and thus may one day find themselves subject to equally restrictive legal scrutiny.[13] The thresholds set by IP laws for access to protected works are calibrated so that rivals need to innovate to compete effectively. Consumers benefit from a system that regularises independent, competitive innovation and an efficient distribution of regulatory resources which they ultimately fund with taxes. However, in terms of legal strategy, the most important players are dominant firms. As the subject of competition complaints, they have the most immediate

also W. A. Sheramata, "Barriers to Innovation: A Monopoly, Network Externalities and the Speed of Innovation" (1997) Antitrust Bulletin 955. For a discussion of the standard theory, see M. A. Lemley, "The Economics of Improvement in Intellectual Property Law" (1997) 75 Texas Law Review 993–1000.

[11]C. Saez, "Panel: IP Rights in Standards Impede Competition, Disadvantage Developing Countries" Intellectual Property Watch, (July 17, 2008), online: Intellectual Property Watch http://www.ip-watch.org/weblog/index.php?p=1155.

[12]Europe levied fines of more than US $2.4 billion against Microsoft, and is still investigating the company for possible violations related to its Office suite and Internet Explorer browser. In Asia, the Korea Fair Trade Commission fined Microsoft US $32 million in 2005, and ordered the company to create versions of Windows XP that did not include Windows Media Player and Windows Messenger. See G. Keizer, "China Denies Reports of Microsoft Antitrust Investigation" Computerworld, (June 19, 2008), online: Computerworld http://www.computerworld.com/action/article.do?command=viewArticleBasic&articleId=9100818; Intel is the world's largest producer of semiconductors and the dominant chip used in PCs and servers. Its war with regulators is over the global semiconductor market, valued at about $273 billion in 2007. See S. Ferguson, "Intel Cooperating With FTC Probe," E-Week, (June 9, 2008).

[13]"(N)o man can be sure that he may not be tomorrow the victim of a spirit of injustice, by which he may be a gainer today." A. Hamilton, "The Federalist No. 78," P. B. Kurland, and R. Lerner eds., *The Founders' Constitution* (University of Chicago Press, 1987) 527–529, online: The Founders' Constitution, Popular Basis of Political Authority http://press-pubs.uchicago.edu/founders/documents/v1ch2s22.html.

vested interest in reshaping restrictive legal doctrines, and are perhaps in the best position to initiate the necessary legal changes or construct ways to avoid or even use restrictive doctrines to their advantage.

This paper first considers the nature and form of Interface strategy. It examines why IP strategies invoke regulatory responses and evaluates the legitimacy of those responses. It observes that there is a clear divergence between American and European regulatory responses.[14] It argues that, while imperfect, the current American approach more satisfactorily balances competing interests and promotes the holder's ability to maximise the strategic value of their IP in international markets. The final section then discusses two strategies for those who desire to maximise the potential of their IP portfolio. First, firms should support and attempt to influence the adoption of economic theory that counsels regulatory restraint. While this is not easy, today, more courts and regulatory bodies in Europe and the United States (US) in particular, are more interested in economic theory and economic realities than ever before. Second, with the economic growth and marketplace importance of Asia, prudent multinationals should seek to influence the emerging legal norms in these countries, while being sensitive to the limits of their influence. Today it is not enough to be able to exploit IP under the laws in the United States and Europe. Restrictive competition laws in China or India could as a practical matter force marketplace changes worldwide. Today, clever market rivals might think first about bringing complaints about a dominant competitor to competition authorities in the European Union (EU), rather than the USA, for the reasons discussed below. In the not too distant future, those same rivals might do even better by bringing complaints to authorities in emerging markets where anti-multinational feelings and fears of dominance over locals might more likely enable them to prevail. Thus, multinational market leaders should not stand by while competition law norms develop in markets in Asia and elsewhere.

While it might seem that Interface legal strategies might be the same for all IP, there is a perceived greater need for the intervention of competition law in the areas of patents, as they potentially confer the greatest exclusionary power and thus the greatest potential for anti-competitive conduct.[15] Thus, this paper will focus on the Interface with regard to patents.

[14]The discussion will be primarily concerned with developments in America and Europe due to their continuing dominant influence internationally on competition law. See Dhall (n 1) 31.

[15]As a consequence of the narrower scope of protection, copyrighted works are rarely the source of significant market power. While copyright protection of software interfaces has arisen as a source of anti-competitive concern in *Microsoft* for example, these instances are rare. Thus, principles can be considered under the patent rubric. Dominant trademark owners are expected to keep a tight control over the production and sales of their goods and services and thereby to protect their sign as a badge of origin. "Competition policies forcing companies to license their trademark or preventing them from including clauses to control the behaviour of their licensee would ultimately be counter-productive as they would remove the firm's incentive to provide consumers with high quality goods." Régibeau and Rockett (n 3) 56.

20.2 Legal Strategy at the Interface: Theory and Form

To be successful, firms both large and small need to know the strategic possibilities available to them and to have the ability to exploit these possibilities.[16] To evaluate strategic possibilities, firms must first understand the underlying regulatory and judicial terrain. This section focuses on that terrain and introduces related concepts that will be explored more fully in Sect. 20.3.

20.2.1 The Quest for the Golden Mean

The free market form of economic organization has been credited with causing extraordinary growth and innovation, such growth largely due to the competitive pressures placed on the firms.[17] While these competitive pressures are beneficial, they also cause firms to devise strategies to reduce those pressures. If these strategies take place in the context of protecting IP, the question arises as to what extent competition law should recognise the validity of practices considered valid under IP law. If one views IP protection as an engine for competition then it can be argued that a level of deference is warranted under competition law for practices valid under IP law even if they disadvantage competitors. In this context, competition law might be viewed as a "second tier" of regulation.[18] One of the practices that might be given some deference is the right of owners to refuse to provide access to

[16] "Legal outcomes are the products of complex human interactions in which the lawyer can draw not just on written law, but on social norms and prejudices, the law in action, the law in lawyers' heads, informal rules of factual inference, apparent system imperatives, community expectations regarding legal outcomes, and virtually anything else that might persuade the decisionmaker. Strategy can constrain judges and other decisionmakers – or replace them altogether. No a priori limits on this process exist, in or outside of the law. The strategic possibilities are almost limitless, which accounts for the importance of creativity and imagination on the part of the strategist. The skilled strategist knows that one can no more predict the outcome of a case from the facts and the law than one can predict the outcome of a game of chess from the positions of the pieces and the rules of the game. In either case, one needs to know who is playing." LoPucki and Weyrauch (n 2) 1472.

[17] "(T)here are substantial reasons to conclude that the patently extraordinary growth record of the free-enterprise form of economic organization is hardly accidental, and that it is in large part attributable to the pressures of the free market upon the business firm, which force it to spend liberally and continually on the innovation process and to make its innovations available to others if those others are willing to pay an attractive price." W. J. Baumol, *The Free-Market Innovation Machine: Analyzing The Growth Miracle of Capitalism* (Princeton University Press, 2002) 19 [Baumol].

[18] "The competition policy of the Commission under Article 82 continues to function as a second tier of regulation of the exercise of intellectual property rights in general and in the information technology field in particular." Anderman (n 6) 23.

their protected works to their competitors, even for a fair amount of remuneration.[19] On the other hand, for those who view IP as a monopoly that inherently needs monitoring, the deference approach does not carry much weight. This paper discusses the differences in the approaches taken by the United States and European Union in detail below. Deciding which of the pro or anti-IP levers to push is part of the natural strategy choices firms are faced with when determining how litigation issues will be presented and choosing the litigation venue.

The right of a single firm to refuse to license its IP is perhaps the most important Interface issue today. Those advocating intervention by competition law when IP owners refuse to license do so principally on two grounds. First, they argue that firms with significant market power in an upstream market could use its ownership of proprietary interfaces to monopolize derivative downstream markets. Such conduct is generally viewed with suspicion as the interoperability of complementary products increases the attractiveness of the owners' products. It is therefore inferred that efforts to prevent access stem from ambitions to dominate the downstream markets. Some hold the view that intervention is particularly justified where the IP concerned is of a "low innovative quality" and there is therefore little justification to refuse access.[20]

Alternatively, the IP itself may be beyond reproach but external factors such as network effects are perceived to have unjustifiably accrued to confer on IP owners more control over market conditions and innovation than warranted with respect to the risk undertaken or their investments of time, skill and effort.[21] Early in the standardisation process, industry members might easily be able to abandon one

[19]"[A]n obligation imposed upon the proprietor of a protected design to grant to third parties, even in return for a reasonable royalty, a licence for the supply of products incorporating the design would lead to the proprietor thereof being deprived of the substance of his exclusive right." *AB Volvo v. Eric Veng (UK) Ltd.*, [1988] E.C.R. 6211, para. 8, Case C-238/87; For a discussion of refusals to deal from the US and EU perspectives, see R. Pitofsky, "Challenges of the New Economy: Issues at the Intersection of Antitrust and Intellectual Property" (2001) 68 Antitrust Law Journal 919–923; See also S. Chalkley, "International Licensing and Competition Law Considerations in Licensing Transactions Affecting the European Economic Area" (2008) 927 Practicing Law Institute / PAT 202.

[20]"Indeed, there has been an unprecedented expansion in the subject matter covered by intellectual property: in the length of terms of protection; in the robust nature of exclusive rights; in the ability to use a complex array of legal strategies in conjunction with new forms of technological control over expression; and even in the myriad of available civil and criminal sanctions." S. Wilf, "The Making of the Post-War Paradigm in American Intellectual Property Law" (2008) 31 Columbia Journal of Law and the Arts 140; "Since issuing its first patent for a tax strategy in 2003, the Patent and Trademark Office has issued at least 52 patents covering specific tax strategies. Another 84 published applications for tax strategy patents are pending." S. Seidenberg, "Crisis Pending" (May 2007) American Bar Association Journal, online: ABA Journal http://abajournal.com/magazine/crisis_pending/; For a critique of these issues, see generally D. Lim, "Regulating Access to Databases through Antitrust Law: A Missing Perspective in the Database Debate" (2006) Stanford Technology Law Review 7, online: Stanford Technology Law Review http://stlr.stanford.edu/pdf/lim-antitrust.pdf.

[21]M. L. Katz, and C. Shapiro, "Network Externalities, Competition, and Compatibility" (1985) 75 American Economic Review 424.

technology in favour of another. However, once the level of resources committed to the standard rises and the costs of switching to a new technology mount, users may find themselves locked into the chosen technology. Regulators are concerned that this result has little to do with the functional superiority of a particular technology and is perpetuated only by the strategic use of IP to exclude better entrants.[22] Ownership gives them the ability to preserve or strengthen their dominant position in their own upstream market or to acquire a dominant position in a derivative downstream market.[23] Regulators are also concerned that IP owners may engage in rent seeking behaviour which would harm downstream consumers when excessive royalties are passed on to them, or retard cumulative innovation because of patent hold-ups.[24]

In either case, IP owners no longer exploit IP in a manner that corresponds to its essential function of inducing investment to produce products and services beneficial to consumers. Owners thus become vulnerable to regulatory intervention. Because IP entails some level of exclusion, it becomes a question of to what degree this conduct should be tolerated. The fact that the net effect of restricting free competition may enhance consumer welfare makes the overall assessment more complex and controversial. The analysis is further complicated by the fact that the ultimate effects on consumers often manifest themselves in the distant future. Consumers do not immediately bear a higher price or face a sudden reduction in supply. In these circumstances, there is the danger that any regulatory action would be premature because it could under or overestimate the anti-competitive harm. In order to regulate effectively and therefore in a manner consistent with underlying policies, regulators have to balance tangible short-term benefits of lower prices and convenience against sometimes speculative long-term harm to innovation and consumer welfare. The entire analysis revolves around a single point: the quest to achieve an optimal balance between the incentive to innovate by the owner or third parties, and the welfare of consumers or technological progress for the market as a

[22]D. P. Majoras, "Recognizing the Procompetitive Potential of Royalty Discussions in Standard Setting" (23 Sept. 2005), Remarks at Conference on Standardization and the Law: Developing the Golden Mean for Global Trade, online: Federal Trade Commission http://www.ftc.gov/speeches/majoras/050923stanford.pdf.

[23]Thus in the European case of *IMS v. NDC*, IMS was the leading supplier of market reports concerning sales of pharmaceutical products in Germany. It allegedly held a copyright over a modular structure it used to gather pharmaceutical data and then produce its market report, and strategically employed the asserted right to exclude its new competitor from the market. See *IMS Health GmbH & Co. OHG v. NDC Health GmbH & Co. KG*, [2004] E.C.R. I-5039, Case C-418/01 [*IMS Health*].

[24]"A dominant firm leading the race in research and development intentionally selects a technology for which scale economies are substantial, knowing that the fringe firms will have to follow along. Alternatively, a firm may create an array of patents on marginal or even non-existent innovations, knowing that other firms will either have to invent around the patents or else litigate their validity." H. Hovenkamp, *Federal Antitrust Policy: The Law of Competition and its Practice,* (Thomson West Publishing, 1994) 286.

whole.[25] This is the quest for the golden mean and it is a quest that has caused one of the deepest rifts in competition policy.[26]

20.2.2 The Trans-Atlantic Divide

The antitrust statutory provisions in the United States and the competition law treaty provisions in the European Union have similar constructions. They both seek to address single firm conduct and conspiracy and agreements in restraint of trade. Moreover, both require a certain amount of economic power before scrutinising single-firm conduct.[27]

Differences in the laws do exist, however, at least with regard to single-firm conduct. They stem not so much from the language of the relevant provisions as from the underlying policy approaches. US regulators generally do not intervene in unilateral refusals to license, particularly when rivals complain.[28] They tend to

[25]"They are torn between laissez-faire markets and interventionist visions of the state in organizing economic affairs." J. E. Lopatka, and W. H. Page, "Economic Authority and the Limits of Expertise in Antitrust Cases" (2005) 90 Cornell Law Review 636 [Lopatka and Page]; See also W. H. Page, "Ideological Conflict and the Origins of Antitrust Policy" (1991) 66 Tulane Law Review 1 discussing the place of various ideologies in the development of national antitrust policy.

[26]The divergence between the American interpretation of "monopolization" and "abuse of dominance" in Europe has been called "the single most problematic" area that exists in transatlantic competition policy today. See D. P. Wood, "The U.S. Antitrust Laws in a Global Context" (2004) Columbia Business Law Review 272.

[27]American law prohibits monopolization and attempts to monopolize. Section 2 of *The Sherman Antitrust Act* punishes, with a fine or by imprisonment or both, "every person who shall monopolize, or attempt to monopolize, or combine or conspire with another person or persons, to monopolize any part of the trade or commerce among the several States." See *The Sherman Act* 15 U.S.C. § 2 [*The Sherman Act*]. European law prohibits the abuse of dominance. Article 82 of the European Community (EC) Treaty expressly establishes that "any abuse by one or more undertakings of a dominant position within the common market or in a substantial part of it shall be prohibited as incompatible with the common market in so far as it may affect trade between Member States." See Article 82 of the Treaty Establishing the European Community, 2006 O.J. (C 321) E/37, 74–75 [EC Treaty].

[28]"Antitrust liability for mere unilateral, unconditional refusals to license patents will not play a meaningful part in the interface between patent rights and antitrust protections. Antitrust liability for refusals to license competitors would compel firms to reach out and affirmatively assist their rivals, a result that is 'in some tension with the underlying purpose of antitrust law.' Moreover, liability would restrict the patent holder's ability to exercise a core part a core part of the patent – the right to exclude." Promoting Innovation (n 4) 6 quoting *Verizon Commcations Inc. v. Law Offices of Curtis v. Trinko, LLP* (2004), 540 U.S. 398, 407–408 [*Verizon v. Trinko*]; In elaborating the bases for the freedom-not-to-deal principle, the Supreme Court in *Verizon v. Trinko* stressed that duties to deal are duties to assist rivals, and duties to assist rivals usually harm competition and innovation. Firms will tend to invest less in property that they must share with rivals. Moreover, as for Section 2 duties in general, it is hard to distinguish illicit exclusion from legitimate competition, and "[m]istaken inferences and the resulting false condemnations are especially costly, because they chill the very conduct the antitrust laws are designed to protect." *Verizon v. Trinko*,

believe that too little action is less of a risk than too much and intervention to protect weaker firms may serve only to blunt competition for the sake of uncertain benefits.[29] The EU on the other hand has shown a greater propensity to control conduct by a dominant firm. They are more suspicious of actions for which competitors complain. They have less faith in the marketplace by itself to produce a beneficial result. The EU's desire to create a single market was long believed to account for this divergence. However, it has been observed that the force of this argument has diminished in recent years.[30]

In the United States, single-firm conduct is not scrutinised unless it has monopoly power. Even then, the critical question is whether the firm acquired or maintained its monopoly power in the relevant markets unlawfully.[31] To be illegal, a monopolist's conduct must have an anti-competitive effect, harming the competitive process and thereby consumers. Regulators must prove that there is a real probability, and not simply a possibility, of market exclusion.[32] This means evidence of an actual impact on the market in order to demonstrate harm to consumers.[33] Where proof of harm to consumers is shown, the dominant firm may still justify its actions by establishing a valid business justification. The exclusive right

414 quoting *Matsushita Elec. Industrial Co.* v. *Zenith Radio Corp.,* (1986) 475 U.S. 574, 594; Even apart from false positives, the detailed supervision that a sharing obligation requires may be "beyond the practical ability of a judicial tribunal to control." *Verizon v. Trinko*, 414 quoting *Brooke Group Ltd.* v. *Brown & Williamson Tobacco Corp.,* 509 U.S. 209, 223 (1993); "I]n the absence of any purpose to create or maintain a monopoly, the act does not restrict the long recognized right of trader or manufacturer engaged in an entirely private business, freely to exercise his own independent discretion as to parties with whom he will deal . . . ." *Verizon v. Trinko*, 414 quoting *United States v. Colgate & Co.*, (1919) 250 U.S. 307.

[29]"[T]he means of legitimate competition are myriad . . . mistaken interferences and the resulting false condemnations are especially costly, because they chill the very conduct antitrust laws are designed to protect." *Verizon v. Trinko* (n 28) 414; See also E. M. Fox, "What is Harm to Competition? Exclusionary Practices and Anti-competitive Effect" (2002) 70 Antitrust Law Journal 371 who notes that although actual proof of consumer welfare diminution is not expressly required by the Sherman Act nor by other statutory provisions, an exclusionary conduct will not be punished lacking clear evidence of consumer harm.

[30]"In the past, European competition law has been seen to diverge from antitrust law in other jurisdictions, primarily due to its market integration motive. However, over the past few years less weight appears to be have been given to this aim, reflecting the fact that the European market has indeed become more integrated." P. Marsden, and S. Bishop, "Intellectual Leaders Still Need Ground To Stand On" (2007) 3 European Competition Journal 315.

[31]See *United States v. Grinnell Corp.* (1966), 384 U.S. 563, 570–571 [*Grinnell Corp.*] which held that the offense of monopolization requires "the willful acquisition or maintenance of that power as distinguished from growth or development as a consequence of a superior product, business acumen, or historical accident."

[32]"(T)he plaintiff, on whom the burden of proof of course rests, must demonstrate that the monopolist's conduct indeed has the requisite anti-competitive effect." *United States v. Microsoft Corp.* (2001), 253 F.3d 34, 58–59 (D.C. Cir) [*U.S. v. Microsoft*].

[33]"Concrete evidence of market behavior ranks higher than the kind of inference proof heavily relied on by the Government." *Grinnell Corp.* (n 31) 585.

conferred by IP law might serve as an objective business justification for refusing to license.[34]

As noted, US regulators generally believe that too little action is less of a risk than too much.[35] Regulators prefer to concentrate on conduct that directly restrains output or increases price to the immediate detriment of consumers. They trust market forces to drive rivals to independently seek economic efficiencies in order to displace incumbents.[36] The US Supreme Court recently noted that charging of monopoly prices, at least for the short term, is lawful and an important element of the free-market system that fosters innovation and economic growth.[37] This "light touch" approach to dominant, single-firm conduct has been criticised because of the concern that the short term restriction of competition might not be offset by long-term innovation benefits.[38] *Rambus* exemplified the extent of the reluctance of US courts to intervene.[39]

Rambus was charged with manipulating industry standard setting procedures in favour of its own proprietary technologies by a course of deceptive conduct as a member of an industry standard-setting organization (SSO). Rambus disclosed its patent position and demanded royalties only after its technologies had been incorporated into the relevant standards and the members had made substantial investments to accommodate them. The court reasoned that if Rambus' technology would have been selected as a standard in any event and Rambus' deception only affected the size of the royalty payments, then there was no anti-competitive effect. Thus, if regulators could not definitively find that Rambus' monopoly was caused by deception, then Rambus was a lawful monopolist and its "use of deception simply to obtain higher prices normally has no particular tendency to exclude rivals."[40] This conclusion neglects the fact that the SSO's decision to adopt a standard in the first place would inevitably have been affected by considerations of cost. Even though the regulators could not determine whether the SSO would have rejected the Rambus technology or negotiated lower royalties in the counter-factual world without deception, there was ample evidence from which regulators

[34]Ibid.

[35]See *Verizon v. Trinko* (n 28) 414.

[36]"Competition is a ruthless process injuries to rivals are byproducts of vigorous competition, and the antitrust laws are not balm for rivals' wounds." *Ball Memorial Hospital Inc. v. Mutual Hospital. Insurance Inc*., (1986) 784 F.2d 1325, 1338.

[37]"The opportunity to charge monopoly prices – at least for a short period – is what attracts 'business acumen' in the first place; it induces risk taking that produces innovation and economic growth." *Verizon v. Trinko* (n 28) 407.

[38]See Arezzo (n 3) who notes that a light regulatory touch risks twofold consumer harm. The market may suffer an immediate restriction of competition in the short run without the promised subsequent wave of innovation guaranteeing that the best technology would prevail.

[39]*Rambus* (n 9).

[40]Ibid 11; The FTC includes conduct covered by antitrust law, and uses the same reasoning. "§ 5 reaches all conduct that violates § 2 of the Sherman Act. Therefore, we apply principles of antitrust law developed under the Sherman Act." ibid.

could conclude that the SSO never would have adopted patented technology in a standard without any idea of its cost.

The EU diverges mainly in its treatment of abuse of dominant position and has shown a greater propensity to control conduct by a dominant firm. When EU regulators have established that a firm has a dominant position, irrespective of the reason for the dominance, the firm has a special responsibility not to allow its conduct to impair genuine undistorted competition.[41] Consumer harm is presumed whenever there is a "distortion of competition" caused by the very presence of the dominant owner on the market.[42] However, there is an important counterbalance. The general rule has been that only under "exceptional circumstances," the prerogative to refuse access to use protected works can be curtailed in favour of a more competitive structure of the market. Therefore, dominant IP owners may be found to abuse their dominant positions if, without a legitimate business justification, they refuse access to non-duplicable inputs indispensible to the viability of other businesses, and where their refusal prevents a new product to be provided to meet verifiable consumer demand in order to reserve for themselves, a downstream market.[43]

The fact pattern that would meet that test would be unusual. Generally, the IP owner will fully exploit all commercially viable markets. It is unlikely, therefore, that IP owners would ignore potential markets for their technology, giving third parties basis for complaining that market demand is not served. The "new product" requirement guides regulatory intervention toward a dynamically efficient outcome. It ensures that dominant firms are actively blocking new viable markets by letting their unexploited IP create a bottleneck to other firms' innovation.[44]

In recent years, the EU has zealously pushed for interoperability and open access. With regard to standards, it has taken the view that markets alone cannot properly determine standards. Indeed, regulators have gone so far as to propose the

[41]"A finding that an undertaking has a dominant position is not in itself a recrimination but simply means that, irrespective of the reasons for which it has such a position, the undertaking has a special responsibility not to allow its conduct to impair genuine undistorted competition on the Common Market." *Nederlandsche Banden Industrie Michelin NV v. Commission*, [1983] E.C.R. 3461, Case C-322/81, para. 57.

[42]"Article 82, like the other competition rules of the Treaty, is not designed only or primarily to protect the immediate interests of individual competitors or consumers, but to protect the structure of the market and thus competition as such (as an institution), which has already been weakened by the presence of the dominant undertaking on the market." *P British Airways Plc v. Commission*, (2007) O.J. C 82, Case C-95/04, para. 69.

[43]"[I]n order for the refusal by an undertaking which owns a copyright to give access to a product or service indispensable for carrying on a particular business to be treated as abusive, it is sufficient that three cumulative conditions be satisfied, namely, that that refusal is preventing the emergence of a new product for which there is a potential consumer demand, that it is unjustified and such as to exclude any competition on a secondary market." *IMS Health* (n 23) para. 38.

[44]Economic theory posits that allocative efficiency is achieved by mandating access to competitors, stimulating competition in downstream markets. On the other hand, dynamic efficiency is achieved by refusing access, thereby protecting the return on the IP owner's investments and its ex ante incentives to invest and compete dynamically.

consideration of new legislation that would mandate open standards by dominant players in order for their software to be sold in Europe.[45] Divergent competition policies between the EU and America have led some American companies to bring their antitrust battles against a dominant competitor to the competition authorities in the EU. This was evident in the European Commission's case against *Microsoft*.[46] The decision in *Microsoft* demonstrated that the access to networks issue is where the USA–EU rift is perhaps starkest.

Microsoft was accused of shifting its market power from the upstream client operating systems market to the downstream workgroup server operating systems market. The Court of First Instance (CFI) found that rivals needed a fully functional interface to compete with Microsoft's server products, as well as the same degree of compatibility that exists between the Microsoft's servers and the Windows operating systems for personal computers. The existing level of interoperability was found to be inadequate because users choosing between competing software products will almost always prefer the one with full interoperability, even if its internal features may be functionally inferior. The CFI brushed aside Microsoft's suggestion that there were at least five other ways to achieve interoperability short of compulsory licensing, on the basis that they were not commercially viable. It also held that the criteria laid down by previous case law were not exhaustive. The relevant yardstick was whether the increase in the industry incentives to innovate outweighed any decrease to Microsoft's incentives.[47] It was therefore sufficient for complainants to show that their products might have had new or innovative features benefiting consumers and that they were not allowed to compete on equal footing with Microsoft's products in the market covered by Microsoft's IP. The court also held that Microsoft bore the burden of showing that the refusal was objectively

[45]"[F]or all future IT developments and procurement procedures, the Commission shall promote the use of products that support open, well-documented standards. Interoperability is a critical issue for the Commission, and usage of well-established open standards is a key factor to achieve and endorse it. This policy, adopted last year, needs to be implemented with vigour." N. Kroes, European Commissioner for Competition Policy, "Being Open About Standards" (June 10, 2008) Speech/08/317 OpenForum Europe – Breakfast Seminar, Brussels, online: Rapid – Press Releases – Europa http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/08/317&type=H [Kroes]; See also S. M. Fulton, III, "EC's Kroes Advocates Mandatory Enforcement of Open Standards" (2008) BetaNews (June 10, 2008) quoting Commissioner Neelie Kroes, "[w]here equivalent open standards exist, we could also consider requiring the dominant company to support those too."

[46]*Microsoft Corp.* (n 8) para. 563.

[47]Ibid para. 706 where the Court held that "on balance, the possible negative impact of an order to supply on Microsoft's incentives to innovate is outweighed by its positive impact on the level of innovation of the whole industry (including Microsoft)." The Court extended the concept of new product by finding that this requirement should be interpreted in accordance with Art. 82(b) of the EC Treaty, which lists "limiting production, markets or technical developments to the … prejudice of consumers" as an abuse of a dominant position. For that reason, the stifling of an entirely new product is not the only circumstance in which Art. 82(b) is engaged. Limitation of technical developments was also sufficient.

justified.[48] Microsoft was thus ordered to disclose the specifications of the interfaces of the Windows workgroup server operating system to direct competitors.

20.2.3 Evaluation of the Regulatory Response in Microsoft

Microsoft is another recent EU decision that has incorporated economic analysis. The balancing rhetoric, however, seems shallow and arbitrary. The CFI, without acknowledging it, has moved beyond precedent to reach its result. Moreover, because the decision is so tied to the particular facts, there is room for it or other courts to avoid it as a precedent. Thus, it appears to have little practical value in predicting what the next case will bring, although ironically it probably emboldens the European Commission as to what it thinks it will be able to do. Even the former president of the CFI and one of the judges on the case has expressed discomfort with the decision and the amount of discretion it appears to give to the Commission.[49] The outcome has raised the suspicion that the real answer to the question "what is an abuse" is "whatever the European Commission and courts says it is." At the least, the decision has muddied EU competition rules for access to IP. Not surprisingly, the decision has been controversial and criticised.[50]

20.2.3.1 Evidence of Harm

The fact that EU law does not require verifiable evidence of consumer harm makes it difficult for dominant firms to determine whether regulators are going to view a

[48]"[I]t is for the dominant undertaking concerned, and not for the Commission, before the end of the administrative procedure, to raise any plea of objective justification and to support it with arguments and evidence. It then falls to the Commission, where it proposes to make a finding of an abuse of a dominant position, to show that the arguments and evidence relied on by the undertaking cannot prevail and, accordingly, that the justification put forward cannot be accepted." *Microsoft Corp*. ibid para. 688.

[49]See D. Lawsky, "EU Microsoft Judge Fears Decision May Hurt Investment" L. Gervitz ed., Reuters, (March 12, 2008), online: Reuters http://www.reuters.com/article/reutersEdge/idUSL1254538020080312?pageNumber=2&virtualBrandChannel=0 who notes that the Commission now has a wide margin of appreciation and it has a duty to choose its cases carefully.

[50]"The 'new features' reinterpretation fundamentally undermines the balance struck by the ECJ." B. Batchelor, "The Fallout from Microsoft: The Court of First Instance Leaves Critical IT Industry Issues Unanswered" (2008) 14(1) Computer and Telecommunications Law Review 18 [Batchelor]; "[T]he test of 'convenient facilities' has found its way into EU law," and that "This aggressive policy of the Commission, coupled with the use of the 'convenient facilities' doctrine by the Courts in the interpretation of Art. 82, is bound to send a chill down every software innovator's spine." K. Lahiri, and S. Sivakumar, "'Interface Information': 'Abuse of Dominant Position' and Compulsory Licensing in The Indian Context – Can EU Law Resolve the Ambiguities?" (2008) 14 Computer and Telecommunications Law Review 26 [Lahiri and Sivakumar].

particular course of conduct as problematic. All the plaintiff has to show is that the conduct is capable of causing harm.[51] The key then is market dominance and the competitors' need for the dominant firms' IP. While it is clear that this is a relatively low standard, the precise threshold is vague. However, *Microsoft* has made the threshold for access even more plaintiff friendly. The court in *Microsoft* did not address how much of the access information refused was needed to make other producers of workgroup servers sufficiently viable. Neither did it give any guidance on how viable the rivals must be. It is very rare in the technology markets for rival products to have the same feature set. Complainants will almost always be in a position to claim that with additional IP licensed from the dominant licensor, they could produce improved products with new features that consumers would value. A vendor of associated software that requires interface information to a product which has achieved market dominance will be able to claim that a full interface is essential to compete in the associated software market. It does not matter that there was no stifling of a new product market. Microsoft supplied the server operating system software. It is worth highlighting, that past European case-law warned against the setting of too low an access threshold, which would dampen innovation incentives.[52] Accordingly, the circumstances in which complainants can claim new features will be far from "exceptional." The result of *Microsoft* is that rivals seeking to produce competing products now get access under its new standard.

Naturally, there has been a plea for regulators to show verifiable evidence that consumer harm is likely in European cases.[53] The best touchstone for intervention is perhaps "the new product" requirement as understood pre-*Microsoft*. "New products" refers to functionally different products which are not currently being offered by the owner. They are not merely functional enhancements but add an inventive step to the patented product, either in a derivative or transformative manner.[54] This understanding incorporates the principal that an erosion of the

[51] "For the purposes of establishing an infringement of Article 82 EC, it is sufficient to show that the abusive conduct of the undertaking in a dominant position tends to restrict competition or, in other words, that the conduct is capable of having that effect." *Manufacture Francaise des Pneumatiques Michelin v. Commission*, [2003] E.C.R. II-4071, Case T-203/01, para. 239.

[52] "The incentives for a dominant undertaking to invest in efficient facilities would be reduced if its competitors were, upon request, able to share the benefits." *Oscar Bronner GmbH & Co. KG v. Mediaprint Zeitungs*, [1998] E.C.R. I-7791, Case C-7/97, para. 57.

[53] See P. Rey, et al., "Report by the EAGCP, An Economic Approach to Article 82" (July 2005), online: Report by EAGCP http://ec.europa.eu/comm/competition/publications/studies/eagcp_july_21_05.pdf who argues that European assessment of abuse of dominance should move towards the American approach and only declare anti-competitive a conduct that causes an immediate consumer welfare diminution; "A complainant or regulator should be put to the higher standard of proof of showing a genuine likelihood of elimination or marginalisation of competitors, not simply a possibility of such exclusion." Batchelor (n 50) 17–22.

[54] "[T]he outcome in *IMS* differed sensibly from *Magill* because IMS' refusal to license was not directed at preventing a new product from entering the market. Instead, NDC Health as the entrant simply wanted to compete in the provision of market reports, a product already offered by IMS." Arezzo (n 3) 489.

exclusive IP right can only be justified by a corresponding net increase in technological advancement.[55] So the burden of proof should be on regulators to show that there is in fact a new product that benefits consumers which would not be offered because of the dominant firms' refusal to grant access. This conclusion was very important for Microsoft in the USA The claim that the bundling of Windows with Internet Explorer was detrimental could therefore not be proven.[56]

Related to this is the theory of inefficient "lock-ins" that was accepted in *Microsoft*.[57] There is a view that even after the market has settled on an industry standard, competition in the market must continue unabated. Under this view, the "new product rule" is ineffective where network effects prevent rivals from placing new products in the market. Where competition by substitution is not possible, the right holder's freedom not to license would result in overbroad protection. The argument goes that if the IP right does not have the capacity to promote dynamic efficiency, a duty to deal should be accepted so as to guarantee at least allocative efficiency.[58] Further, incumbents have full incentives in the primary market, and an open access requirement involving a secondary market will have no effect at all on those incentives.[59] The fact that most networks arise over time, allows incumbents to reap sufficient returns to justify the initial investment and risk taking. These arguments are flawed for the following reasons.

First, those who say lock-ins impede visible competition may well be right. However, if they meant that lack of visible competition stifles the industry's incentives to innovate and harms consumer welfare, they would be going beyond their evidence. There are many examples where control of proprietary standards failed to impede dynamic competition and there has not been any convincing proof of negative lock-ins. Instead, studies show that many consumers prefer a minimum number of providers, so that positive network externalities are maximised. So while the IP owner may enjoy monopolistic entrenchment, the intra-system competition

[55]"This is exactly why the Commission has elaborated an ad hoc test (the Magill test) with its own prongs which makes it different from both mere essential facility test and mere refusal to deal assessment." ibid 502–503.

[56]The District of Columbia Court of Appeals in *Microsoft* stated that: "We do not have enough empirical evidence regarding the effect of Microsoft's practice on the amount of consumer surplus created or consumer choice foreclosed by the integration of added functionality into platform software to exercise sensible judgment regarding that entire class of behavior." *U.S. v. Microsoft* (n 32) para. 94.

[57]*Microsoft Corp.* (n 8) para. 651.

[58]"[A]n obligation to deal under competition law would make economic sense to promote allocative efficiency … the innovation argument should not help the dominant undertaking since there is not the slightest economic guarantee that excessive revenues for the dominant firm would be reinvested in innovation" J. Drexl, "IMS Health and Trinko – Antitrust Placebo for Consumers Instead of Sound Economics in Refusal-to-Deal Cases" (2004) 35(7) International Review of Intellectual Property and Competition Law 805.

[59]B. Frischmann, and S. W. Waller, "Revitalizing Essential Facilities" (2008) 75 Antitrust Law Journal 1 [Frischmann and Waller].

for improved components make the network attractive for both producers and users. Further, other factors such as customer service, product marketing and technically superior products also play an important role in determining that which will ultimately dominate.[60]

Innovation is the prime competitive weapon among large, high-tech business firms and remains so even for incumbents.[61] While network effects do exist and must be overcome, these are weak forms of lock-in. If the new product is superior, it will be worth the switching costs. If the price is too high, people will switch or come up with independent non-derivative alternatives, similar to the situation where a gas station raises its prices and a regular customer breaks free of its lock-in of habit to travel to a further but cheaper station.

Second, although monopolies or market dominance may be inevitable in technology markets, concentrations of market power are inherently fragile. Innovation helps to create a strong element of self correction, making such markets workably competitive even where markets shares are high and sustained.[62] Competition in technology markets allows rival products to leapfrog each other either by offering greater functionality at a lower price or by producing the next new product.[63] There will always be technologies that win and technologies that lose. The people who made horse carriages were not the ones who started automobile companies. Mainframe computers were not displaced by other mainframe computers but by a new disruptive technology in the form of the personal computer. Innovative industries tend to produce strong market leaders and *de facto* industrial standards.[64] However, innovation is not driven by those who complain that competitors are not buying into their products because they've been locked in. Instead, innovation is driven by those who see opportunity in adversity. As William Baumol noted:

> The market mechanism achieves much of its efficiency and its adaptation to consumer desires through financial incentives, by providing higher payoffs to those firms that are more efficient and whose products are most closely adapted to the wishes of consumers. The same mechanism obviously drives innovation in an even more powerful way. For oligopoly firms in the high-tech sectors of the economy, it is in fact a matter of survival. The firm that lets its rivals outperform it substantially in innovative products or processes is

[60]For a general discussion and critique of this issue, see D. Lim, "Copyright Under Siege: An Economic Analysis of the Essential Facilities Doctrine and the Compulsory Licensing of Copyrighted Works" (2007) 17 Albany Law Journal of Science & Technology 481.

[61]Baumol (n 17) 4 citing the computer industry as the most obvious example, "whose new and improved models appear constantly, each manufacturer battling to stay ahead of its rivals."

[62]"[I]nnovation to a large degree has already rendered the anti-competitive conduct obsolete (although by no means harmless) … and broader structural remedies present their own set of problems, including how a court goes about restoring competition to a dramatically changed, and constantly changing, marketplace." *U.S. v. Microsoft* (n 32).

[63]R. Schmalensee, "Antitrust Issues in Schumpeterian Industries" (2000) 90 American Economic Review 193.

[64]M. L. Katz, and C. Shapiro, "Antitrust in Software Markets," J. A. Eisenach ed., *Competition, Innovation, and the Microsoft Monopoly* (Kluwer, 1999) 29.

faced with the prospect of imminent demise. The firm must innovate or die. To paraphrase Dr. Johnson, the prospect of hanging is a powerful stimulus to the imagination.[65]

Today, we see products and services converge through the Internet into a single global marketplace. With the digitalisation of so many IP products, anyone can access the Internet and get songs, music, and software, many for free.[66] So many more people can choose not to be stuck at the bottom of a vertical distribution chain without access to alternatives because of segregated geographical markets. However, this convergence has another important effect. Fewer players are needed to meet the exploding global market demand. It is very tempting, and therefore very easy, for these firms to be penalised merely for being so big. Blockages caused by IP can spur superseding innovation, not merely derivative or incremental innovation. For example, Skype depended on the development of infrastructural technology. While blockage by telecommunications companies may have reduced competition within the market for fixed line and mobile telephony, it created and fuelled a sustained demand for internet telephony, which is fast becoming the standard for international communication today.[67]

Microsoft's bid for Yahoo in February 2008 signalled a dramatic market transition.[68] This was more than the largest potential technology acquisition ever – the world's largest software company had realised that the Internet had displaced the PC as the centre of the technology universe. The functions offered by Microsoft's operating system and office productivity suites might soon be duplicated and improved upon in a way that would appreciably erode Microsoft's market position and eventually displace it if it continued on its strategic trajectory. So while regulators around the world may have hastened Microsoft's decision to open up,

[65]Baumol (n 17) 10.

[66]Sergey Brin and Larry Page saw in a market dominated by Yahoo, Alta Vista and AOL, Internet surfers who wanted quick, unbiased, and comprehensive Internet search results. They won the market and changed "Google" into an everyday verb. Apple saw in Napster, Kazaa and Grokster consumer demand for online, unbundled music and offered iTunes. They bypassed OEM and PC channels which regulators were convinced had been tied up. Gnutella enables PCs to share files, computing power over the Internet and bypasses the need for a central server and the companies that control them. In the software arena, Download.com offers freeware alternatives to proprietary software. For a more comprehensive treatment of this issue, see D. Lim, "Beyond Microsoft: Intellectual Property, Peer Production and the Law's Concern with Market Dominance" (2008) 18 Fordham Intellectual Property, Media & Entertainment Law Journal 291.

[67]Today VOIP has already been taken to the next level. Mobile phones are using the technology, accelerating the obsolescence of traditional telecommunications networks, and together with them, the potential bottlenecks. See I. Tham, "New Entrant to Offer Cheap Wi-Fi Calls," Digital Life, (June 16, 2008) who notes that "MediaRing, it uses the Wi-Fi feature in mobile phones to bypass traditional GSM networks."; "Local telephony is one example of a network that eventually became infrastructural over time and may cease to be in the future as a result of technological developments, most notably wireless telephony and Voice over Internet Protocols (VoIP)." Frischmann and Waller (n 59) 34; The entire digital music industry last year was worth about US $4 billion. See O. G. Lee, "He's Got The Whole Music-Sharing World in His Hands," Digital Life, (June 10, 2008).

[68]S. Lohr, "Yahoo Offer Is Strategy Shift for Microsoft," N.Y. Times, (February 2, 2008).

Microsoft itself has recognised that the old world is disappearing. In this new world, Microsoft, just like anybody else, has a business model that either works or does not. Shutting its windows will mean irrelevance in an interconnected world. By working towards making its software more accessible, Microsoft is hoping to become a more integral part of new programs and services. Microsoft is not alone. To win market share from BlackBerry, Apple unveiled its iPhone software development kit earlier this month together with a 100 million dollar "iFund" to finance budding entrepreneurs who want to develop programs for it.[69] Depending on exclusionary conduct such as infringement suits and refusals to license are short-sighted tactics. So too with tweaking software licenses to increase profits. These are not hallmarks of firms that will lead the technology industry with strategic vision. Successful strategies focus on customer needs through vision and R&D that delivers significant innovation – anything less, and the dominant incumbent will only be minding the store until the next leader arrives. It is at best doubtful whether regulatory intervention could provide any added value to this process.

The third flaw in the theory of inefficient lock-ins is that regulatory focus on preventing the expansion of IP rights beyond their scope presumes that notional borders between legitimate and illegitimate returns can be clearly delineated. The reality is that markets, particularly technology markets, do not have sharp edges delineating where one product ends and the next begins.[70] As American regulators recently acknowledged in their review of the Interface:

> (T)he boundaries of intellectual property rights are often uncertain and difficult to define, so that neither the intellectual property holder nor competitors know the precise extent of protection afforded by the intellectual property right . . . The value of intellectual property typically depends more on its combination with other factors of production, such as manufacturing and distribution facilities, workforces, or complementary intellectual property, than does tangible property. . . The application of antitrust law to intellectual property requires careful attention to these differences.[71]

It is simplistic to assume that every strategy involving the exploitation of network externalities is unjustified. Networks are the end product of hard work, meticulous strategizing and some luck. Penalising network effects discounts the intense competition aimed at "building an installed base" of users in order to offer a more attractive product than the rival. Technology networks that achieve market dominance are not merely isolated pockets of innovation. Thomas Edison is remembered today as the inventor of the incandescent light bulb, although light bulbs had been made by many others before Thomas Edison. The reason for Edison's commercial success was that he was the first person to develop a complete electrical distribution system – bringing electricity to an entire city, and not just one room.[72]

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[69]C. Cain Miller, "V.C. Advice to Entrepreneurs: It's Not All About the iPhone," N.Y. Times, (July 25, 2008).

[70]I am grateful to Professor V. Korah for making this point.

[71]Promoting Innovation (n 4) 4.

[72]Knight (n 5) 63.

Taken to its logical conclusion, the zeal for static efficiency means that owners have no right to refuse access, even if consumers suffer no verifiable harm because they are denied functionally interchangeable products. There is a danger that new competition authorities, eager to show results, will be tempted to intervene where prudent economics counsels otherwise. Even European law has clearly recognised that competition and IP laws both promote innovation and dynamic competition by excluding imitation.[73] If the substance of IP is the right to refuse access, then what remains of this right if courts can force access even if the market is being served? If it can be accepted that owners deserve to be rewarded for their creativity and labour in successfully developing a standard, then surely the onus is on complainants, even if they are regulators, to show that owners do not deserve to benefit from them. Similarly, if regulators want to displace the market-driven standard, the burden is surely on them to show conclusively why or how they can do better. To do so based on theories of "perpetual exclusion" opens them to accusations of speculation. To do so based on assessments of the innovativeness of a patented invention begs the question as to whether it is their place to sit as arbiters of IP offices that grant these rights. It is suggested that rather than require access for the sake of promoting visible competition, it may be more meaningful to consider how competition and IP policies can properly be used to align innovation incentives with the innovator's contribution.

20.2.3.2 Competitor Driven Litigation

Traditionally, private competition lawsuits have been more common in the United States than in Europe, perhaps owing to the triple damage remedy which makes it very attractive to sue rivals there. It is striking that, despite the rhetoric that intervention was to benefit consumers in *Microsoft*, consumers themselves played no part in bringing the action.[74] Rather, the action was initiated and fuelled by rival complaints from the USA.[75] While the outcome of rival-driven complaints may sometimes benefit consumers, it is a counter-intuitive result. It tempers the threshold for regulatory interference as any doctrine established is double-edged and can

[73]See application of art. 81(3) of the Treaty to categories of technology transfer agreements in Council Regulation (EC) No. 772/2004, 2004 O.J. (L 123) 11; "In its Guidelines on the Transfer Technology Regulation, the Commission has sufficiently made clear that IP rights and competition law coincide in promoting innovation and dynamic competition by excluding imitation." H. Apostolopoulos, "Refusal-to-Deal Cases of IP Rights at the Aftermarket in the US and EU Law: Converging of Both Law Systems Through Speaking the Same Language of Law and Economics" (2007) 7 Chicago-Kent Journal of International and Comparative Law 165–166.

[74]"What should we make of the fact that not one consumer rights organization (and there is at least one in every Member State) did not intervene in support of the Commission?" P. Marsden, "Picking Over The CFI Microsoft Judgment Of 17 September, 2007" (2008) 20 Loyola Consumer Law Review 174 [Marsden].

[75]P. Meller, "Rivals of Microsoft File Antitrust Complaint in Europe," N.Y. Times, (July 29, 2003).

equally wound the successful complainant at some future point. At the same time, private litigation may be used abusively and dampen aggressive entrepreneurship.[76] It is true that both rivals and consumers share a platform against the owners' anti-competitive conduct, but at the same time, because rivals are themselves profit-seeking firms, the outcomes they seek are competitive markets that provide them with a greater share of profits whether or not consumers benefit from the changed market conditions.[77] Rivals seek a "level playing field" even though this often means a set of rules designed to prevent larger firms from exploiting efficiency advantages.[78] Rivals are equally susceptible to strategic behaviour, and may initiate complaints to prevent IP owners' pro-competitive behaviour by raising the defendant's costs and exploiting the owners' aversion to the uncertainty as to the outcome of litigation.

20.2.3.3 Burden of Proof

Article 81 of the EC Treaty[79] bifurcates the prohibition from the justification.[80] In contrast, Article 82 does not and dominant firms only have the evidentiary

[76]Seven reasons have been suggested: (1) extortion of funds from a successful rival; (2) changing the terms of the contract; (3) punishing non-cooperative behaviour; (4) responding to an existing lawsuit; (5) preventing a hostile takeover; (6) discouraging the entry of a rival; and (7) preventing a successful firm from competing vigorously. See R. P. McAfee, and N. V. Vakkur, "The Strategic Abuse of the Antitrust Laws" (2004) 1 Journal of Strategic Management and Education 3 [McAfee and Vakkur]; See also W. F. Shughart II, "Private Antitrust Enforcement Compensation, Deterrence, or Extortion?" (1990) 13 Regulation 53 who notes that "(c)ritics contend that the treble damage remedy promotes protracted litigation, encourages nuisance suits designed to extort large monetary settlements, and creates perverse incentives that magnify rather than mitigate the social cost of monopoly in the economy."

[77]W. J. Baumol, and D. F. Bradford, "Optimal Departures from Marginal Cost Pricing" (1970) 60 American Economic Review 265.

[78]McAfee and Vakkur (n 76) 37–38; "It would be foolish to expect that an antitrust system primarily driven by the competitor-distributor class would tend toward consumer welfare . . . to the extent that litigants shape the content of liability rules, the competitor-distributor class will tend to promote rules that favor its class – generally smaller business interests – over the business interests of the defendant class, which usually consists of larger business interests." E. A. Snyder, and T. E. Kauper, "Misuse of the Antitrust Laws: The Competitor Plaintiff" (1991) 90 Michigan Law Review 551.

[79]EC Treaty (n 27).

[80]The devolution of competition law to national competition authorities via Council Regulation (EC) 1/2003 of December 16, 2002 has raised the concern that national courts may arrive at outcomes which conflict with competition policies of both its sister states as well as the EU as a whole. Firms operating in the EU should take heed and tread cautiously; "It had been a fundamental of competition law thinking that this exclusivity was necessary to provide coherence in the application of the law in this area. Given that these exemptions are very broadly worded, there was fear that if exemptions could be granted by other institutions, they might be granted inconsistently and perhaps in ways that favored domestic interests." See D. J. Gerber, "Two Forms of Modernization in European Competition Law" (2008) 31 Fordham International Law Journal 1235, 1240;

burden with regulators bearing the legal burden throughout. *Microsoft* marks a crucial change from settled precedent and presents an obtuse reading of Article 82. Since it is difficult to establish the extent of benefits and detriments to competition, the burden of proof can be decisive.[81] Assessing justifications is a fact-intensive process involving complicated economic assessments of the kind where courts will give considerable deference to regulators in all but cases of manifest errors. The CFI left open whether Microsoft's reduced incentive to innovate could legitimately be claimed as a defence. On the facts, Microsoft's evidence of harm was found to be too vague and was countered by evidence that licensing of interfaces was common in the industry without harming innovation.[82] It is disappointing that this argument was not examined in more detail since in many industry sectors, forced licensing of IP may well have a very adverse impact on innovation incentives.

20.2.4 The Impact of Regulatory Responses on IP Strategies

In their quest for the golden mean, US and European regulators have settled on different views on the extent of intervention necessary. While the current American approach may be vulnerable to accusations of entrenching incumbents, the current EU approach too easily displaces them. Both rely on subjective notional balancing mechanisms, and this can hardly be satisfactory. It is difficult for firms to know, even under the uncertainty expected in litigation, how cases might be decided. Further, European thresholds for access are much lower than the USA, adding the risk of false positives in regulatory intervention. It may certainly be argued that US policy similarly raises the possibility of false negatives. Perhaps the way to determine the best approach to promoting innovation is simply to look at how innovative a society is. According to a 2008 RAND report, America is still the world's science and technology powerhouse.[83] It accounts for 40% of total world spending on research and development and produces 63% of the most frequently cited publications.[84] It is home to 30 of the world's leading 40 universities and employs 70% of the world's living Nobel laureates.[85] America produces 38% of patented new technologies in the Organisation for Economic Co-operation and Development

For a discussion of the challenges and opportunities in the decentralisation of European Competition Law, see T. Rodríguez de las Heras Ballell, "Decentralised Application of EU Competition Law: A Strategic Approach" (2004) CLaSF Working Paper Series, No. 5, online: CLaSF Working Paper Series http://www.clasf.org/assets/CLaSF%20Working%20Paper%2005.pdf.

[81]My thanks to Professor V. Korah for sharing this thought.

[82]*Microsoft Corp*. (n 8) paras. 698–703.

[83]T. Galama, and J. Hosek "U.S. Competitiveness in Science and Technology" (2008) (RAND Corporation, National Defence Research Institute, 2008), online: Rand Corporation, Document Information http://www.rand.org/pubs/monographs/MG674/.

[84]Ibid xvi.

[85]Ibid.

(OECD)[86] and employs 37% of the OECD's researchers.[87] If America's approach causes it to suffer from false negatives, it is nonetheless not doing too badly.

European theories of harm are informed by decades of legal rulings that dominant firms have a "special responsibility" to their customers and their rivals.[88] The problem is that it is very difficult to identify exactly what duties attach to "special responsibility." Originally, this was a unique development in competition law, but it is now very much the law throughout Europe. It may be conceded that for a range of reasons in European markets, market forces have traditionally not been as effective as in other markets in constraining dominant firm conduct. Such reasons include the historic creation of many dominant firms by the state and the continued segmentation of markets and consumer preferences along national lines. However, when considering product markets that are global, a different approach should be taken.

Microsoft is poised to be a much cited precedent in the technology industry. Firms should take refusal to license complaints seriously and evaluate the risk that their strategies bring under the new test. Indeed, international firms may want to confirm their behaviour in all global markets to the European standard. As Philip Marsden put it:

> (*Microsoft*) highlights the fact that divergences remain between Europe and the US when it comes to technology-driven markets. US courts would not accept the theories adopted by the Court of First Instance this morning. This is hardly an ideal regulatory environment for companies in global technology-driven markets. It leads to difficult choices: should dominant companies say yes to a demand for technology from a US rival that has no foundation in US law, but which might be accepted in Europe?[89]

What is unthinkable today may be tomorrow's convention, and it will be dangerous if the world converges with respect to the most restrictive norms. The corollary to helping competitors too readily may be that innovation in the market will be held back because vigorous innovation and competition becomes more risky. Studies in Europe have found that companies will only invest in innovation and R&D if they are certain that they will be able to reap the rewards of that investment.[90] It is noteworthy that when Hewlett Packard decided to install an enhanced search feature by Microsoft in all its PCs, European markets were conspicuously absent from the markets which would benefit from this feature.[91]

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[86]Ibid.

[87]Ibid.

[88]*Microsoft Corp* (n 8) para. 229.

[89]Marsden (n 74) 174.

[90]Report from the High Level Group Chaired by Wim Kok, "Facing the Challenge: The Lisbon Strategy for Growth and Employment" (November 2004) European Communities, 2004, online: Facing the Challenge http://www.grad.ac.uk/downloads/documents/Reports/European%20reports/Wim%20Kok.pdf.

[91]I. Tham, "Microsoft, HP in Search Deal," Digital Life, (June 10, 2008).

This may be an indication that dominant technology firms are already reassessing their global IP strategies.[92]

Regardless, it would be naïve to expect that the current US and EU positions represent their final, idyllic resting place. The history of competition policy is one of sharp paradigmatic dislocations, with differences in views arising out of different eras.[93] The USA has shown signs that regulators are prepared to take a more active role in restricting the ambit of IP strategy. US regulators, who had never acted to halt the exercise of IP rights without some nexus to an antitrust violation, have now done so.[94] This suggests that regulatory policy will now target perceived abuses of IP rights that affect consumers, even sophisticated corporate consumers, in the absence of antitrust violations. On the other hand, European regulators have shown themselves committed to refining their competition rules, and have engaged stakeholders in a consultative review process of rules on dominance.[95] However, they are constrained by European case-law and ironically, by the many cases they have previously won.

It would also be simplistic to believe that this is a contest between two homogeneous policies. It is more likely that the tensions observed between the USA and EU will manifest themselves wherever different factions have different views as to when the golden mean has been satisfactorily achieved.[96] Indeed, some factions

[92]A complaint filed with the Commission late last year by smaller rival Opera Software claims that Microsoft should not be allowed to bundle its browser software with its dominant Windows operating system. See J. Letzing, "Microsoft Files U.S. Antitrust Report as China Law Looms," MarketWatch, (June 18, 2008); EU investigators have opened a case against Intel, arguing that the rebates and discounts the company offered to OEMs to use only Intel's chips were complemented by bids to provide components below cost, all in an effort to prevent AMD from gaining design wins. South Korea's Korean Fair Trade Commission also fined Intel $21 million for alleged abuse of its dominant market position. The state of New York has also launched an antitrust investigation of Intel. Meanwhile, AMD as well as Japan, argue many of the same points that the U.S. investigation is expected to pursue. See M. Hachman, "FTC Preparing Antitrust Investigation of Intel," ExtremeTech, (June 6, 2008), online: ExtremeTech http://www.extremetech.com/article2/0,1558,2317434,00.asp.

[93]See D. A. Crane, "Antitrust Modesty" (2007) 105 Michigan Law Review 1210–1211 who argues that modern American antitrust history is not characterised by gradual change but instead by significant shifts in dominant schools of thought over different time periods.

[94]See Federal Trade Commission, "In the Matter of Negotiated Data Solutions, LLC" (January 23, 2008) FTC File No. 510094, online: Federal Trade Commission http://www.ftc.gov/os/caselist/0510094/index.shtm where the regulators made an unprecedented conclusion that the defendant's attempt to obtain more favourable terms constituted an "unfair method of competition" and an "unfair or deceptive act or practice" and violated Section 5 of the Federal Trade Commission Act (incorporating antitrust rules) even in the absence of an antitrust violation.

[95]European Commission, "DG Competition Discussion Paper on the Application of Article 82 of the Treaty to Exclusionary Abuses" (December 2005), online: European Commission, DG Competition http://ec.europa.eu/comm/competition/antitrust/others/discpaper2005.pdf.

[96]"It is simplistic to assume that because some intellectual property protection is good, that such protection should therefore be absolute in all circumstances. It is simplistic to assume that because standardisation sometimes brings benefits, more standardisation will bring more benefits. It is simplistic to assume that if the best approach is sometimes to base a standard on proprietary

may sometimes find more in common with their supposed antagonists across the Atlantic than among their own fold. So it must be emphasised, that in any description of a European or American position, there is always a risk of generalisation and inaccuracy.

In the current regulatory environment, it is in the interest of firms to encourage a commitment to restraint and clarity with regard to how competition laws should be implemented. This does not prevent the enforcement of competition laws but it does imply that conditions under which the use of market power will be restricted must be as unambiguous as possible. Stability in the system reduces strategic behaviour by firms, and allows regulatory resources to be more efficiently allocated.[97] With globalisation and liberalisation of markets, it is even more imperative for Western firms seeking a foothold in these markets that this stability be achieved. Indeed, competition laws are generally extra-territorial, and firms may find themselves targeted by foreign regulators as long as a case can be made that the effects of their strategies are felt there.[98] Firms may fare best by employing firm resources to strategically cultivate national and international competition culture and thus direct the fulcrum of change.

20.3 Navigating the Interface: Global Trends and Future Prospects

Competition laws essentially exist as creatures of policy. Regulators and courts are often guided by broad and vague statutory mandates which provide them with a

technology, then that is always the best approach. And it is simplistic to assume that we can fix on a standard today, without paying attention to the risk of being locked-in tomorrow." Kroes (n 45); See also, Commission of the European Communities, "Communication from the Commission to the European Parliament, the Council and the European Economic and Social Committee: An Industrial Property Rights Strategy for Europe" (July 16, 2008) Brussels, COM(2008) 465/3, online: Commission of the European Communities http://ec.europa.eu/internal_market/indprop/docs/rights/communication_en.pdf?info=EXLINK which notes that "it is generally not for competition law to second guess a specific IP policy of a standard-setting body, but rather to provide guidance on which elements may or may not be anti-competitive. It is for industry to choose which scheme best suits its needs within these parameters."

[97]See J. van Sinderen, and R. Kemp, "Strategic Interactions In Competition Policy: Dutch Experiences" (2008) 29 European Competition Law Review 309 who note that "[i]t is important to keep institutional arrangements as stable as possible, and changes in the competition law should only take place when the social benefits of such amendments are higher than the social costs."

[98]The "effects" doctrine is now a settled part of international law and Organisation for Economic Co-Operation and Development (OECD) guidelines expressly caution multinationals of this. See OECD, "OECD Guidelines for Multinational Enterprises," online: OECD, Directorate for Financial and Enterprise Affairs http://www.oecd.org/document/28/0,2340,en_2649_34889_2397532_1_1_1_1,00.html.

wide discretion in implementing the law.[99] Adjudicated outcomes depend considerably on the ideologies of the adjudicators. Those associated with particular legal norms are influenced by them when accepting or rejecting arguments advanced by different socio-economic or political schools. If achieving the golden mean involves manipulating purely notional concepts to achieve intended policy aims, then economic analysis may be seen as yet another malleable instrument.[100]

Firms may use strategies to direct legal and other norms that influence the outcomes of cases.[101] In this regard it is important to understand that judges and regulators, like everyone else, may be influenced by many things other than legal doctrine including not only legal and economic norms but also social, moral and political ones as well. The key is to persuade first, and then provide a doctrinal way to achieve the desired result.[102] Thus, while judges and regulators ultimately determine the outcome, firms may affect that outcome by looking to influence the spectrum of norms and the doctrines of course, that affect them. As a practical strategic matter with regard to the Interface, firms should concentrate on economic

[99]"Although there is presently wide consensus on antitrust's goals, legitimacy, and limitations, the antitrust statutes are highly general and open textured and thus provide vehicles for implementing many vastly different political agendas." D. A. Crane, "Technocracy and Antitrust" (2008) 86 Texas Law Review 1221; See also P. Marsden, and S. Bishop, "Intellectual Leaders Still Need Ground To Stand On" (2007) 3 European Competition Journal 315 quoting the Judge Rapporteur in *Microsoft* as saying, "I tell my clerks that these (Article 81 and 82) cases are 20 percent fact, 20 percent law and 60 percent policy." This is because economists are likely to adopt a model identifying previously unrecognised causal factors in a market phenomenon. Coase presents a number of instances in which the vast majority of economists adopted a newly presented theory without any evidence at all that it made accurate predictions. See Lopatka and Page (n 25) 634–635.

[100]See A. Majumdar, "The Role of a Consumer Harm Test in Competition Policy" (2008) 20 Loyola Consumer Law Review 148 who notes that "[the] trade off is very difficult to assess and the consumer harm principle is too high-level to shed any additional light on the practical realities of making the correct assessment."

[101]"The task of persuading the decisionmaker at the normative level is often an urgent one. Decisionmakers, particularly those who conceptualize law as a generally consistent set of rules that inform and bind their decisions, may frame the issue in accord with the first persuasive argument and be unable to give fair consideration to equally persuasive but conflicting arguments. Once the decisionmaker is persuaded at the normative level, the task of persuasion at the doctrinal level is easier and less urgent. The strategist need only provide the decisionmaker with legal doctrine that plausibly links the facts of the case to the strategist's desired conclusion. That other legal doctrines plausibly link the facts to other conclusions presents no real danger at this late stage. Presented with a bridge to the 'right' conclusion, the decisionmaker is unlikely to adopt a doctrinal rationale that leads to a conclusion he or she believes is wrong." LoPucki and Weyrauch (n 2) 1437.

[102]"Conventional legal theory assumes wrongly that decisionmakers will apply written law to the exclusion of social norms, maintains falsely that expectations regarding outcomes are the direct product of written law, and does not even recognize the existence of the law in lawyers' heads. Were these assumptions accurate, legal strategists would have relatively few tools to employ. In fact, written law is sufficiently malleable that decisionmakers can interpret it to support virtually any position that finds support in social norms or expectations regarding outcomes. That is, whatever exists in a fact pattern that gives rise to rights or entitlements under social norms will find support in legal doctrine." ibid 1434–1435.

norms[103] and the relevant legal culture – the climate of social thought and social force that determines how the law is used, avoided or abused.[104] In order to maximise the strategic value of their IP, firms should actively seek to mould both factors.

20.3.1 Shaping Economics

While some have argued that economic theory has been integral to the development of competition laws and framed much of competition litigation,[105] the reality is that it is only in the last 30 years in the United States and more recently in the EU that it has played a significant role. The question then is what role does economic theory actually play. Of course, economic theories, like legal doctrine, might be selected based upon how well they allow courts and regulators to achieve a desired result. If used with intellectual honesty, however, they are chosen because they "serve as a base for thinking" and help people to "understand what is going on by enabling [them] to organize [their] thoughts."[106] While they all claim to have predictive accuracy, they are rarely subjected to an empirical appraisal to test their accuracy. Economic theories can be used to identify the sorts of factual inquiries necessary to determine whether liability is appropriate.

This process of judicial adoption of economic authority implicitly recognises that economic knowledge is socially constructed.[107] Thus, economic theories need

[103]See Lopatka and Page (n 25) 620 and description of the US Supreme Court's adoption of the Chicago School's economic models. The antitrust problem, in Chicago terms, is to identify the likely effects of the practice on efficiency. Efficiency is now accepted as the most, or even sole, relevant goal of US antitrust regulation.

[104]"The existence of local legal cultures, all supposedly 'governed' by the same written law but generating markedly different outcomes, is not only possible, but inevitable. Written law can be applied only through the medium of a mental model. Most of those models are produced interactively in local communities. The community's shared mental model does not exist in complete isolation from the written law; to the contrary, members of the community usually study the written law for useful ideas. They may confuse it with the shared mental model and be intent on reproducing it in their own minds. The effort is, however, futile because the written law is too complex. Because the shared mental model of a given legal community is in no sense a replica of the written law and because communities work to some degree in isolation from other communities, it is inevitable that they will produce shared mental models that differ from community to community." L. M. LoPucki, "Legal Culture, Legal Strategy, and the Law in Lawyers' Heads" (1996) Northwestern University Law Review 1543.

[105]"Antitrust policy has been forged by economic ideology since its inception." H. Hovenkamp, *Enterprise and American Law 1836–1937* (Harvard University Press, 1991) 268–269.

[106]See R. H. Coase, "How Should Economists Choose?" *Essays on Economics and Economists* (University of Chicago Press, 1994) 16–18 who argues that a theory "serves as a base for thinking" and "helps us to understand what is going on by enabling us to organize our thoughts."

[107]See R. Pitofsky, "The Political Content of Antitrust" (1979) 127 University of Pennsylvania Law Review 1065 who notes that "economics provides no system for reliably determining economic effect," and economic tools do not approach scientific reliability, and as a result, antitrust enforcement along economic lines already incorporates large doses of "hunch, faith, and intuition."

to be consistent with the decision makers' norm preferences as well. The question then becomes, how are norms established and why are they adopted? While this inquiry is beyond the scope of this article, we can see that economic norms are adopted in part, because they are accessible, make sense and are proffered or adopted by those whose judgment can be trusted.

Perhaps the best way to influence judicial and regulator decision making is to make accessible a body of academic commentary and criticism that present a coherent school of thought.[108] Firms should enlist the aid of academics in this process, not in the sense of "buying" them, but rather by making sure that academics who do believe in norms that are valuable to the firms' views become known. By facilitating an accessible body of academic commentary and criticism that presents an alternative, coherent "school of thought," it is arguable that firms can facilitate change, providing specific grounds for displacing and discarding the doctrine they criticise.[109]

Generally, American antitrust policy has been guided by the Chicago School and its progeny, while European competition policy has been guided by the Freiburg School.[110] While it is true that economic theories have no nationality, where a theory comes from can be either a negative or a positive for adoption of that theory. "Foreign" ideas are generally less likely to be adopted than domestic or local ones. Thus, multinationals must look to those within their jurisdiction to make the case for the norm.

Economic models can have two major drawbacks. One is that they are simply academic exercises. The other is that they are subject to norms, national and other biases. The answer to both drawbacks is to test these models and theories against their real world results. The goal here is to benefit consumers. Thus, economic theories or models and their concomitant legal doctrines must be justified by real world performance. Therefore, a legal doctrine with regard to alleged exclusionary practices may produce too many false positives with regard to harm and not enough successful economic results.[111] Just as the law insists on proof that a given practice is bad for consumers, so too it must insist on proof that intervention based on an

[108]See A. I. Gavil, "A First Look at the Powell Papers: Sylvania and the Process of Change in the Supreme Court" (Fall 2002) Antitrust 9-11 who argues that commentators like Bork and Posner, as well as their predecessors, Director, Levi, Telser, and Bowman, facilitated change, providing specific grounds for displacing and discarding the doctrine they criticised.

[109]See Lopatka and Page (n 25) 634–635 and description of how Chicago School theorists played an integral part of the development of legal standards in antitrust through institutional and written indoctrination.

[110]"What has become known as the Freiburg School or the Ordo-liberal School was founded in the 1930s at the University of Freiburg in Germany by economist Walter Eucken and two jurists, Franz Böhm and Hans Groβmann-Doerth. Ordo-liberalism, an important trend in political economic theory and the theory behind the German social market economy, is based on the assumption that economic system cannot emerge." K. A. Czapracka, "Where Antitrust Ends and IP Begins – On The Roots of the Transatlantic Clashes" (2007) 9 Yale Journal of Law & Technology 55.

[111]See F. Easterbrook, "The Limits of Antitrust" (1984) 63 Texas Law Review 23–25 who argues that competition law interferes with economic efficiency.

economic model does better than the unregulated market. To point to a competitive failure does not necessarily show that regulation is better. Rather than rely on regulators and judges to predict outcomes, it may be better to make judges aware of the limits of the economic models they use. Even the most ardent advocates of intervention by competition law concede this.[112]

20.3.2 Cultivating Culture

Recent years have seen Asian countries enacting competition laws. All are based on Euro-American principles of competition to different degrees.[113] In terms of the impact on the global economy, the most significant ones are China and India.[114] The issues are similar, and for the sake of brevity, Chinese and, to a lesser extent, Indian laws, will be used as a canvas for discussion. As these giant economies progress to the forefront of global trade, the need for more nuanced IP strategies can only grow in significance.

As has been noted above, the differences between EU and US competition law does not stem from words in *The Sherman Act*[115] or the EC Treaty but from underlying differences in competition law policy. Different meanings can and are given to words like "anti-competitive" and "abuse." Likewise, there are different ways of defining markets and assessing market power. Moreover, different countries and regions might have different economic priorities and institutional capabilities. Consequently, they also have distinct competition cultures. Hence,

[112]See J. Drexl, "Abuse of Market Dominance and IP Law – Recent Developments in Europe" who concedes that "[w]hereas economic theory is well advanced with regard to the functioning of price-competition, economics still has a long way to go to develop useful models for a competition policy that promotes dynamic competition." (On file with author).

[113]"Our informal dialogue with Russia has been very constructive. For example we were pleased to share our experience of competition law enforcement with Russia, and were delighted that some of our input inspired recent competition legislation in Russia. China too has just adopted new national legislation – in this case its first anti-monopoly law. From the early stages of the drafting process onwards, we established a structured dialogue on competition policy issues with the Chinese authorities, and this has influenced the content of the law." N. Kroes, European Commissioner for Competition Policy, "European Competition Policy in the Age of Globalisation – Towards a Global Competition Order?" First Symposium in Innsbruck, Forschungsinstitut für Wirtschaftsverfassung und Wettbewerb (FIW), (February 7, 2008), online: Rapid – Press Releases – Europa http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/08/61&format=HTML&aged=0&language=EN&guiLanguage=en; See Lahiri and Sivakumar (n 50) 29 who note that "there is ample opportunity to apply EU law in India, given the provisions of the Competition Act 2002."

[114]The Chinese Anti-Monopoly Law (AML) was adopted by the Standing Committee of the National People's Congress, August 30, 2007, after a 13-year gestation period, and came into force in August 2008. The Indian Competition Act 2002 was amended in 2008 make it more robust. Russia updated its 1991 legislation in 2007.

[115]*The Sherman Act* and EC Treaty (n 27).

despite similar vocabulary, competition laws may lead to different treatment of similar facts.[116] Understandably, Western multinationals are anxious to see where these laws and international best practices converge – and even more anxious to see where they diverge.[117]

Countries at early stages of development are inclined toward information dissemination.[118] Multinational behemoths like Microsoft are seen to present a roadblock to developing countries' initiative to foster a host of home-grown technological companies.[119] Thus, multinational IP owners are concerned that that the line between anti-competitive abuse and the lawful exploitation of IP may be drawn without appropriate deference to the beneficial role that IP can play in technology markets. The owners worry about the risk that competition laws in these countries will be used as a tool to pry open their technology coffers to accelerate the local acquisition of their know-how.[120] There may be more than a kernel of truth to this.[121] Regulators in mature IP markets have joined foreign

[116]"[E]ven when the vocabulary words sound similar, achieving an antitrust meeting of the minds between East and West can be elusive." R. H. Pate, "What I Heard in the Great Hall of the People-Realistic Expectations of Chinese Antitrust" (2008) 75 Antitrust Law Journal 195 [Pate]; "These distinctions remind readers that the law is grounded in Chinese soil, reflecting the basic rules of competition recognized in other market economies as well as special rules tailored for the Chinese socialist economy. The AML is a product of compromise based on existing political and economic realities, and a product guided by pragmatism . . ." Y. Huang, "Pursuing the Second Best: The History, Momentum, and Remaining Issues of China's Anti-Monopoly Law" (2008) 75 Antitrust Law Journal 117.

[117]"The impact of the AML on intellectual property has been a repeated topic of discussion by international commentators." Pate (n 116) 205; For further discussion see also R. Basant, and S. Morris, "Competition Policy in India: Issues for a Globalising Economy," Econ. & Pol. Wkly, (July 29, 2000); See also Dhall (n 1); Predicting that "antirust and information technology will collide in the foreseeable future in the Indian legal scenario." See Lahiri and Sivakumar (n 50) 23.

[118]For example, The Indian Competition Act specifically takes the state of national development into account. For example, the preamble to the Indian Competition Act 2002 states: "An Act to provide, *keeping in view the economic development of the country*, for the establishment of a Commission to prevent practices having adverse effect on competition, to promote and sustain competition in markets, to protect the interests of consumers and to ensure freedom of trade carried on by other participants in the markets, and for matters connected therewith or incident thereto." (emphasis added).

[119]In China, the top among these is Red Flag Software, a leading developer of the Linux operating system, which competes with Windows. It is in the vanguard of companies serving a small but rapidly growing market with Linux-based software and other open-source products, which was worth US $43 million in 2007. See CCID, China Market Intelligence Center, "China Market Research Report," online: CCID, China Market Intelligence Centre http://chinamarket.ccidnet.com/.

[120]"Given the importance for India of acquiring foreign technology, however, the balance may have shifted toward requiring access to patented technology." V. Korah, "Competition Law and Intellectual Property Rights," V. Dhall ed., *Competition Law Today: Concepts, Issues and Law in Practice,* (Oxford University Press, 2007) 140.

[121]"Many foreign companies fear that they may become victims of China's first law against monopolies." Economist Intelligence Unit, "Antitrust Distrust" Business China, (January 16, 2006) online: EIU Online Store http://store.eiu.com/article/859796871.html. Indeed, Chinese authorities were reported to have commenced investigations against Microsoft's use of IP to

owners to call for restraint in interfering with the exploitation of IP.[122] The underlying concern is the vague and subjective standards plaguing unilateral conduct enforcement which creates hazards for a system perhaps already afflicted with corruption and lack of regulator or judicial independence[123] as well as possible bias in favour of small and medium enterprises.[124]

Multinationals need a sense of realism and patience with regard to the development of competition law, particularly with respect to single-firm conduct. Abuse of dominance is a difficult doctrine to implement in mature-market countries and even more so at the early stages of a competition regime's existence. On the other hand, it not unreasonable to seek assurances that local regulators, rules and practices do not discriminate against multinationals. It is also not unreasonable to expect that these rules and practices should not depart drastically from internationally accepted norms.[125] It is likely, however, to expect that local needs will cause divergence from at least some of the mature-market norms.

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charge excessive prices. The reports originated with China's state-run newspaper Shanghai Securities News and the Associated Press, the latter of which quoted a State Intellectual Property Office spokesperson describing the investigation; "Microsoft is seen as a prime target of China's new anti-monopoly law, which is slated to take effect on August 1. The statute, the first of its kind in China, is intended to prevent companies that enjoy market dominance from stifling the growth of homegrown rivals. It signals new vigilance by Beijing with regard to safeguarding competition against powerful and established multinationals, particularly in industries where China is particularly weak, such as computer software . . . But for China, taking on Microsoft serves an additional purpose: to groom a domestic software industry that wants to challenge Microsoft directly by making use of the open-source, Linux-based operating system." S. J. Chen, "China's Antitrust Law Takes Aim at Microsoft" Forbes (June 19, 2008), online: Forbes.com, Market Scan http://www.forbes.com/2008/06/19/microsoft-china-antitrust-markets-equity-cx_jc_0619markets02.html.

[122]See G. F. Masoudi, Deputy Assistant Attorney General, Antitrust Division, "Key Issues Regarding China's Antimonopoly Legislation, Remarks to the International Seminar on Review of Antimonopoly Law" (May 19, 2006) US Department of Justice, online: Department of Justice http://www.usdoj.gov/atr/public/speeches/217612.pdf urging Chinese officials to "make efforts to provide assurances to the domestic and foreign business communities that the Anti-Monopoly Law will be implemented in a way that respects and supports the full and legitimate exercise of intellectual property rights."; "Greater clarity is required to ensure that owners of IP rights will not be prosecuted for merely exercising their rights. Absent such clarification, holders of valuable IP may fear the imposition of compulsory licensing (or compulsory disclosure of technical data) as a sanction for a finding of an abuse based on a mere refusal to license IP or the imposition of conditions in IP licenses that are later determined to be unfair." H. S. Harris, Jr., and R. J. Ganske, "The Monopolization and IP Abuse Provisions of China's Anti-Monopoly Law: Concerns and a Proposal" (2008) 75 Antitrust Law Journal 213.

[123]"Vague standards are an easy refuge for corrupt decision making." Pate (n 116) 209.

[124]"Both China's desire to protect its smaller, rural companies and the existence of local bias in decision making give credence to concerns of foreign companies that the AML will undermine their intellectual property rights." ibid 210.

[125]Thus in response to extensive reports that its regulators were targeting Microsoft for excessive pricing of software, the Chinese government hastily issued a statement categorically denying that any such intent. AFP, "China in Anti-monopoly Probe of Microsoft: State Media" (June 18, 2008); Seattle Times Tech. Staff, "Reports of a Microsoft Antitrust Probe Untrue, China Says" Seattle Times, (June 23, 2008).

Firms therefore need to first acknowledge that local culture and economic needs might make its competition law different from familiar Western variants.[126] It will be counter-productive for firms to approach governments in developing countries like missionaries seeking to convert them to American or European norms. Further, it would be ethnocentric to believe that Western norms of competition are the only viable means of bringing stability and prosperity. The Western view of competition and innovation is one of conflict. Vigorous competition is necessary to competition and the price of this vigour is instability.[127] Asian countries, and in particular China, appear to be anxious to use competition laws to maintain socio-political stability.[128]

Despite deviations from expected competition policy norms, local decision makers should be given the benefit of the doubt that they have a better understanding of history, local needs, and internal balance. Without culturally sensitive engagement, multinational and foreign regulators deprive themselves of the ability to influence the resulting laws, and more importantly, the norms that will drive the application of those laws. Foreign consultants, the local face of the multinational firm, can obtain knowledge of local circumstances but normally it will be relatively limited. These consultants need to engage and assist local regulators in a way that acknowledges the idea that sometimes the right path is one that goes against conventional or contemporary Western beliefs. In short, the willingness to understand leads to understanding which hopefully includes a reciprocal understanding of the legitimate needs and goals of the IP owner.

Global IP strategies must be sufficiently nuanced to take local culture and circumstances into account and influence the growth of the regime from bottom up. For developing countries, this means active engagement through assistance in developing local legal infrastructure. One aspect of this is to support measures to reduce corruption and increase judicial and regulatory independence and expertise.

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[126]"The constant struggle of each company to produce a better, cheaper product or service inevitably results in some companies losing market share-often to the point of dissolving entirely. Competition means instability." Pate (n 116) 200; "The Chinese anti-monopoly legislation should meet the objectives of establishing a unified, open, competitive, orderly, and modern market system in China and of perfecting the socialist market economy system. It should not only be based on the Chinese situation, but it should also borrow from the practical experiences and results of foreign anti-monopoly laws. The law should meet the specific requirements of China, promote the orderly development of the socialist market economy, and comply with common international practices and regulations." Z. Wu, "Perspectives on the Chinese Anti-Monopoly Law" (2008) 75 Antitrust Law Journal 73 [Wu].

[127]"The constant struggle of each company to produce a better, cheaper product or service inevitably results in some companies losing market share-often to the point of dissolving entirely. Competition means instability." Pate (n 116) 200.

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Programs to educate judges and regulators can provide important input into the norms chosen. An international study has found a positive relationship between the quality and education of the judiciary and the quality of the competitive environment. Firms in countries with a high judiciary quality had a low perception of the level of anti-competitive practices by other firms.[129] In the long run, these efforts will likely prove more constructive to transparent and coherent competition law. Once a comfortable level of cooperation has been achieved, multinationals can then suggest ways in which competition regimes may develop mutually beneficial strategies.[130]

20.4 Conclusion

The starting point in corporate IP strategy is the awareness that the Interface is a difficult place to reach a regulatory consensus on permissible unilateral conduct, even between mature competition regimes. The Interface gets to the very edges of known doctrine, and many emerging challenges cannot be resolved by existing policies and rules. The dynamic nature of technology markets makes it harder to establish whether IP-related strategies are pro-competitive or not. Network effects make it efficacious for firms to agree on an industry standard, so that gadgets and software are compatible. But this may confer substantial market power on IP owners, and in turn may bring them into potential conflict with competition policies.

There is an inherent conflict between the policies underlying the two regimes. On one hand, it seems right that IP owners who have passed muster under the threshold for protection and continue to be subject to limitations preventing abuse within IP laws should be allowed a degree of latitude to profit from their contributions to society, even when it distorts a competitive market outcome. Indeed, while it is controversial where the balance is properly made, there is agreement that IP law fundamentally seeks to create this kind of artificial scarcity in order to secure the exclusivity needed to incentivise innovation. On the other hand, there is a legitimate concern that an IP owner's unilateral conduct may exceed the metes and bounds justified by its technological contribution, or even have nothing to do with its contribution, as some have viewed market power owing to network effects. In such cases, the owner's conduct becomes illegal under competition law. There is an element of inherent arbitrariness that can only be addressed over time through

[129] J. M. Mayo, and M. Schiffer, "Antitrust Economics Meets Antitrust Psychology: A View from the Firms" (2006) 13 International Journal of the Economics of Business 281.

[130] "Developing countries are, if anything, more vulnerable to the impact of anti-competitive activities than industrialized nations, whether these activities arise from domestic or overseas enterprises. The enforcement of competition law is therefore, as much a necessity in emerging nations as in the industrialized countries." This is not a mere platitude. See Dhall (n 1) 34.

adjudication, as courts commit themselves to the difficult process of refining the scope of permissible conduct through carefully reasoned opinions.

In the meantime, firms need not be passive subjects of competition rules. Indeed, the most successful firms will be strategic and proactive in engaging courts and regulators in key markets of commercial interest to them. Firms can have significant influence in shaping the economic norms used in applying competition rules. Through effective advocacy and education, they can emphasise that in setting rules, regulators and courts should forego a blinkered adherence to traditional approaches and theories. There may be a temptation, particularly in new national competition authorities, to focus on static efficiency. Static outcomes offer greater certainty and require less preponderance on how innovation works. It is also closer to the kind of work legally trained officials are used to doing.[131] Such temptations make it imperative that theoretical models of efficiency be tested by empirical standards of effectiveness. Evidence of harm should be demanded in parity with allegations under tort, contract or criminal law.

Firms can also influence legal culture. Competition laws are interpreted and implemented according to the specific histories, cultures and circumstances of each country. The diversity of cultural norms makes a single theory of intervention difficult to achieve. It is important for firms to accept that legal outcomes will vary based on local circumstances, and the strategies they take in maximising their IP in one jurisdiction may need to be tailored according to the prevalent institutional and political norms of another. In the context of Asia, Western multinationals should be sensitive to avoid hints of colonialism when engaging Asian stakeholders.

Finally, attention must be paid to global competition law norm setting. There is a temptation for complainants to continually litigate in jurisdictions willing to pry open the IP of dominant firms. Competition regulators and courts in these jurisdictions may be spurred on by this adulation into a race to be the litigation forum of choice. A global climate hostile to the IP strategies of multinationals risks chilling their incentives to expand their geographical operations, or worse, simply stop innovating in fields that are particularly vulnerable to allegations of abuse whether their global operations are too interconnected to easily extricate themselves.

The wheels of commerce are oiled by legal certainty and too little certainty results in sub-optimal innovation and risk-taking. Therefore firms should exercise a measure of circumspection and foresight so that when the dust settles, the playing field will be a sustainable ecosystem that inspires the confidence in existing and potential innovators. Competitors vexed by high toll fees and stingy or non-existent access along a monopolist's innovation highway may find the old-fashioned method of independent, "out-of-the-box" innovation to be a rewarding alternative yet.

As the global economy integrates, firms will have the benefit of greater access to and choice of customers. But globalisation will also create greater challenges of dealing with and developing varying Interface norms. Firms' legal strategies will be

[131]My thanks for Professor V. Korah for sharing this observation.

of necessity more complex and difficult. What is certain is that there will be more competition among firms, among legal strategies and among competition laws. This can only offer more opportunities for the creative legal strategist.

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Part IV
Conclusion: Enlarging The Potential For A "Law And Strategies" Approach

Chapter 21
Applied Advanced Legal Strategy in Court: The Example of the International Criminal Court

Paul J. Zwier and Deanne C. Siemer

Abstract The objective of this chapter is to apply a legal strategy framework to a non-economic context. Through reference to the decision-making process utilised at the International Criminal Court for violations of the Rome Statute, this chapter underscores the importance in considering a "law and management" analysis for any research on legal practice and process and the cogent role that can be played by legal strategy in achieving transparency, objectivity and legitimacy.

21.1 Introduction

Legal strategies are omnipresent in Law despite the fact that they are often concealed or hidden. Consequently, in order to improve their strategic know-how, firms should look beyond the behavior of immediate market players. Indeed, investigations into the behavior of non-governmental organizations (NGOs) or private parties could provide ideas for new legal strategies. Similarly, examination from a legal resource perspective might also be used to enhance understanding in areas other than those surrounding the firm's immediate business relationships.

Certain prosecution-related processes of the International Criminal Court (ICC) provide an interesting opportunity to advance the theory and definition of legal strategy. This opportunity is two-fold. First, it presents an opportunity to test legal strategy theory in the context of a not-for-profit public interest institution.[1] In subjecting the ICC's principled, nuanced, yet realistic approach in the prosecution

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[1]Elsewhere we have applied legal strategy in the classic business litigation context. See for example, D. C. Siemer, F. Rothschild, and P. J. Zwier, *Teaching Legal Strategy* (NITA 2006) [Siemer, Rothschild and Zwier].

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of war crimes to a legal strategy analysis, we hope to be able to demonstrate what is often discussed in the context of commercial business litigation, that is, application of a principled driven strategy can lead to wisdom and have statesman-like effects.

Secondly, it presents an opportunity to examine the strategies of judges and their impact on the relationship between developments in the "rule of law" and politics. The ICC could eventually become the sole permanent court of the United Nations (UN) and perhaps replace the need for future specialty tribunals.[2] As such, the ICC must be able to achieve what specialty jurisdiction courts have achieved – legitimacy and the avoidance of being perceived as arbitrary or capricious in choosing their targets. The ICC must evade being perceived as a political tool of the West.[3] The benefits of deterrence which come with certain, albeit slow, prosecution for violation of International Criminal Law, require that the ICC, at a minimum, survive long enough to receive support from a substantial majority of its members. Thus, in order to survive, the Court must make careful and considered decisions, arguably strategic decisions, that can lead to continued development and implementation of the rule of law without jeopardizing the ICC's legitimacy or mission.

The role of the ICC Prosecutor also presents additional strategic considerations and challenges. The ICC Prosecutor is more akin to a political actor than a judicial official because he lacks the authority typically exercised by a nation state's criminal prosecutor – the authority to make peace or negotiate terms of surrender on behalf of the nation state or its victims. The ICC Prosecutor must not only "do justice," but must do so without the usual authority to bind the member states, thus needing persuasion and moral authority to secure cooperation from its members. Similarly, the member states may negotiate treaties and terms of peace without the authority to bind the ICC in its prosecutions.

In the face of these challenges and in each case, the ICC must consider its true political options while at the same time demonstrating its legitimacy and even-handedness. To survive, the ICC must be able to exercise its prosecutorial functions with rigorous transparency and demonstrated adherence to the objective rule of law principles. But how can this be achieved when "winners" write the rules and "targets" claim a Western bias?[4] The dilemma is that if the ICC pursues certain military actors, it risks losing its funding; if it fails to go after similar cases of

[2]For example see, International Criminal Tribunal for Rwanda (ICTR), the International Criminal Tribunal for the former Yugoslavia (ICTY), the Special Court for Sierra Leone and the Extraordinary Chambers in the Courts of Cambodia.

[3]Of course, this challenge is not unique to the ICC. The United States (US) Attorney's Office currently faces similar challenges to its political neutrality in light of its hiring and promotion criteria, and its decisions as to who and when to prosecute. See *for example* E. Lichtblau, "Report Assails Political Hiring in Justice Dept.," N.Y. Times, (June 25, 2008), online: Report Assails http://www.nytimes.com/2008/06/25/washington/25justice.html?_r=1&pagewanted=print.

[4]For example, Sudanese government leaders claim bias in their prosecution; Similarly, Hutus claim a bias because Tutsi's are not prosecuted; Serbs, because Bosniaks are not prosecuted; Palestinian, because Israelis are not prosecuted; and Charles Taylor backers, because LURD leaders are not prosecuted.

alleged criminal activity, it risks losing its legitimacy and in turn affects the ability of the "rule of law" to deter criminal behavior.

In this article, using the ICC illustration for context, we design a legal strategy matrix, and propose a working definition of legal strategy. We then demonstrate the application of this legal strategy matrix through ongoing reference to the potential prosecution of a hypothetical rebel leader who ends up on the victor's side of a civil war in an African country.[5] This hypothetical was chosen in order to demonstrate

[5]Here, we have in mind a case broadly based on the conduct of Sekou Damante Conneh, leader of Liberians United for Reconciliation and Democracy (LURD), who came out on the victor's side of the Liberian Civil War. While Dictator Charles Taylor has been indicted for using child soldiers, Conneh has not been indicted. We have no information that the ICC is considering the indictment of Sekou Damante Conneh. We use Mr. Conneh only as a way of illustrating the difficulties faced by the ICC in choosing who to indict.As leader of the rebel group LURD, Conneh is an example of a rebel leader who ended up on the side backed by the USA, in opposition to Charles Taylor, who ended up being indicted by the ICC. Conneh takes credit for bringing about the removal of Taylor from his position as president of Liberia. Taylor's resignation on August 11, 2003 came after 13 years of civil war. Taylor left office for exile in Nigeria only when LURD forces laid siege to the Liberian capital of Monrovia. He was later placed on Interpol's "Most Wanted" list, and then indicted by the International Criminal Tribunal for Sierra Leone.On June 20, 2006, the Special Court for Sierra Leone (Special Court) transferred Taylor to the detention centre of the International Criminal Court (ICC) in The Hague for the purpose of using the facilities of the ICC during his trial in accordance with the Memorandum of Understanding (MOU) concluded by the ICC and the Special Court on April 13, 2006. The trial will be conducted by a Trial Chamber of the Special Court sitting in The Hague. The ICC will not conduct the trial of Taylor. Under the terms of the MOU, the ICC will provide courtroom services and facilities, detention services and facilities and related assistance. All costs will be paid in advance by the Special Court through a Trust Fund established by the ICC Registrar. This arrangement will not affect the functioning of the ICC.On March 29, 2006 the then President of the Special Court, Justice A. Raja N. Fernando, had sent a letter to the President of the ICC, Judge Philippe Kirsch, requesting the use of the ICC facilities in order to conduct the trial. In his letter, Justice Fernando, having consulted within the Special Court and with external parties, referred to concerns about the stability in the region should Taylor be tried in Freetown. The ICC sought the views of States Parties on this matter. The Assembly of States Parties subsequently conveyed to the ICC its acceptance of the request of the Special Court for Sierra Leone. Thereafter, the MOU was signed by Judge Kirsch on behalf of the ICC and by Mr. Lovemore Munlo, SC, Registrar of the Special Court.The ICC and the Special Court are independent institutions. The ICC was established by an international treaty, the Rome Statute, to which 100 States are party. The Special Court is an independent tribunal established jointly by the United Nations and the Government of Sierra Leone.As for Conneh, he remains un-indicted. In his attempts to wrest political control from Taylor, Conneh is also thought to have overseen some of the most bloody and destructive battles ever enacted on African soil. Thousands of "child soldiers" served on both sides in the civil war, and LURD forces were responsible for rape, torture, and other atrocities as they fought in the name of democracy and freedom.Conneh's determination to remove Taylor from power, and his willingness to risk his own life in doing so, made him a popular rebel leader, but his links to massacres and extreme violence weighed heavily against him in the run-up to Liberia's long hoped for elections in 2005. In January 2004 his continuing attacks on the capital led his wife Asha Keita-Conneh to declare herself leader of LURD in the first of a series of challenges to Conneh's authority that suggested deep divisions in the organization and eventually led to its collapse as a unifying opposition force. Despite his stated aims to bring peace and democracy to Liberia, observers feared that if Conneh was to take power, his hold over the country would be both authoritarian and divisive. Nevertheless, without his determination and strength of

how a legal strategy approach can provide the transparency and objectivity required by the ICC to justify its decisions in difficult political situations. In the process we also hope to illuminate ways in which the ICC can avoid being perceived as a political tool of Western colonialism and how the ICC's efforts at rule of law development can take the practical realities of its political and funding situation into account while maintaining the objectivity necessary to ensure its mission. In so doing we aim to underscore, the importance of the "law and management" analysis to all research on legal practice and process.

21.2 Legal Strategy and the ICC

21.2.1 Why Consider a Legal Strategy Approach?

In the classic litigation context, strategic thinking processes have typically been viewed through the prism of the adjudicative decision-making system.[6] As such, a "strategic approach" is viewed by many prosecutors as an analysis of: the end game of decision-making; procedural rules; the role of law-fact structures that require syllogistic arguments; and the role of trial court and appellate courts as the arbiters of the law that will finally marry with the facts to reach a reasoned and defensible final decision. The strategy for the lawyer is to gather facts, predict the procedural and substantive rules that will be applied to the case, predict the fact-finders' perspectives that may direct its decision in "non-rational ways" and convey this information to the organization's decision-maker through advice concerning the risks inherent in seeing the process through to its final outcome.

A prosecutor, depending on what he or she sees as the most efficient process for bringing a dispute to resolution might, for example, advise for a range of charges, or for a negotiated, arbitrated, or mediated solution, or might even leave the prosecution to others. Strategy, if it is used at all, is typically part of the decision-maker's choice in light of his or her BATNA, or best alternative to a negotiated agreement/solution. A prosecutor's BATNA is determined in reference to the likely outcome

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will, Charles Taylor's tenure as one of Africa's most brutal leaders would not have come to an end. Sekou Damate Conneh Jr. was born in 1960 in Gbarnga, Liberia. His father, Sekou Damate Conneh Sr., and his mother, Margaret (Makay) Conneh, owned a rubber plantation and farmstead in Bong County. His wealthy father was a chieftain of the Mandingo ethnic group. Though the family was Muslim, Conneh started his education at the St. Martin's Cathedral School in 1966, going on to the William V.S. Tubman Methodist High School where he graduated with a high school diploma in 1979. Conneh's political allegiances forced him to flee Liberia in the early 1980s, but he returned in 1985 and began studying for a Bachelor of Arts in Business Administration at the University of Liberia in 1986. His studies ended the same year when he became a revenue agent working for the Liberian Ministry of Finance. He held this position, working in Rivercess and later Montserrado Counties, until the assassination of President Samuel K. Doe in 1990 and the outbreak of civil war. See Siemer, Rothschild and Zwier (n 1).

[6]Ibid 48.

in the tribunal system. As such, strategy is primarily thought of in terms of trial outcomes. This is arguably what gives a decision objectivity – that criminal prosecution is only compromised in terms of proof efficiencies and not the politics, or even the cost, of winning the case.

Thus, a traditional view of the ICC Prosecutor's role would be that his advice to his office or the Court is given primarily against a backdrop of end game analysis and appears morally neutral on the question of whether to engage in those alternative processes in order to produce a result in line with the ICC's values, or community norms of justice and fairness. This neutrality can be challenged however, because the ICC is faced with such a large number of indictable actors around the world for so many serious crimes against humanity that it is open to the targeted accused to ask, "What about them?" Of course the obvious answer is that the ICC simply lacks the resources to investigate and indict them all. Yet even in the simple process of selecting a prosecutorial target, the ICC becomes vulnerable to attacks and charges of being a political actor – of listening only to the concerns of those established powers that consent to the court's prosecutions. Therefore, there is utility in asking what would be the outcome if a prosecutor applied a more transparent approach to his prosecutorial discretion through an express articulation of how he weighs principles, objectives and mission and, in a practical situation, how he chooses who and for what to prosecute.

21.2.2 Relevance of Strategy to the ICC

The Rome Statute of the International Criminal Court (The Rome Statute)[7] gives the ICC Prosecutor broad discretion to initiate investigations. The Prosecutor is to be independent. Yet, as Mr. Luis Moreno-Ocampo, Chief Prosecutor of the ICC, noted, even the hint of a prosecution or indictment can lead to extensive publicity and can occasionally even affect foreign peace efforts.[8] The consequences of the broad discretionary authority and independence given to the Prosecutor to initiate investigations make him a potential target for criticism from nations and groups adversely affected by his decisions. His decision-making criteria must be transparent and fair or the court's work will be greatly hampered.

The statute does circumscribe the Prosecutor's discretion in some regards. Most investigation requests will come from member states. In rare instances requests may also come from the UN. Even then, member states and the UN may have their own political reasons for complaining about the actions of individuals, states, or groups that operate in another jurisdiction. In addition, an individual state's various political organizations may be beyond the official government's control, or, the state's

[7]Rome Statute of the International Criminal Court, U.N. Doc. A/CONF.183/9 [Rome Statute].

[8]See Discussion with Moreno-Ocampo in "Instrument of Justice: The ICC Prosecutor Reflects" Jurist Legal News and Research (January 24, 2007).

standards for conducting war against insurgents may be still developing. What have evolved are investigations where the ICC is used because of its jurisdictional and investigative powers but where members also negotiate the exact nature of complementarity with the ICC Prosecutor.[9]

The Rome Statute provides that information that would raise questions of violations of the law in a member state can be made known to the Prosecutor from a number of sources.[10] The ensuing investigations, from whatever source, require the Prosecutor to bring his preliminary findings to the Pre-Trial Chamber before proceeding with a full investigation arrest or indictment.[11]

In addition, the Prosecutor must report to the Pre-Trial Chamber if he decides to not investigate a complaint made by a member state. The Pre-Trial Chamber does however have the authority to question that decision if the Prosecutor has relied upon discretionary factors in the statute in making that decision.[12]

Despite these safeguards, the Prosecutor must nonetheless exercise a strategic approach that manages the cases and charging options consistent with the mission and principles of the Prosecutor's Office and the ICC, otherwise the Office will become embroiled in politics. Without a doubt, the Prosecutor's legitimacy will be severely hampered if his strategic decision criteria are opaque and/or appear random and inconsistent. The Prosecutor must therefore be careful to articulate the facts that support indictments[13] and what factors are used to assist in choosing who and when to prosecute.

21.3 A Legal Strategic Framework

We propose that the ICC Prosecutor, as with any institutional actor, might be wise to develop a set of criteria or principles that can bring about a consistent, objective and defensible strategy for processing decisions. Further, we propose that the ICC Prosecutor's Office not only adopt these processes for its internal use but that it

[9]The ICC will complement national courts so that they retain jurisdiction to try genocide, crimes against humanity and war crimes. If a case is being considered by a country with jurisdiction over it, then the ICC cannot act unless the country is unwilling or unable genuinely to investigate or prosecute. A country may be determined to be "unwilling" if it is clearly shielding someone from responsibility for ICC crimes. A country may be "unable" when its legal system has collapsed. See Rome Statute (n 7) Preamble, Arts. 1 and 17(1).

[10]Ibid Art. 15; For example see, Congo, Sudan, Columbia, Cambodia, etc.

[11]Rome Statute (n 7) Art. 15(3).

[12]Ibid Arts. 18–19.

[13]For an excellent example of Moreno-Ocampo's careful defense of his decision to indict a Sudanese government leader, see, "Frost Over the World" (June 20, 2008), online: youtube http://youtube.com/watch?v=gmhokR3224w&feature=user.

might also submit its strategic processes to the Pre-Trial Court for the Court's approval, such that they are transparent to all potential defendants and member states.

As we will describe more fully below, the Prosecutor Office's management of its cases should: (a) institute a shared language – a set of definitions and understanding of law and facts including *horizontal* and *tertiary factors* in light of the *here* of the case, the *there* of the case, the available *time* and available *money resources* – and then; (b) integrated into this shared language, include a five part strategic analysis as follows:

1. The Prosecutor's team should develop and brainstorm a wide set of options that pursue the mission of the ICC in the management of the case.
2. The Prosecutor's team should subject those options to a narrowing analysis of how each option advances the mission of the ICC, for example: justice; punishment/deterrence and retribution; expanded participation of the nation states; and the development of the rule of law.
   Included in this part of the analysis, there should be incorporated careful consideration of any *horizontal factors* such as:

   - The effect of any indictment on any peace efforts
   - Other courts/tribunals with potential jurisdiction
   - The safety of its investigators
   - The safety of witnesses who might be called

There should also be a consideration of any *tertiary factors* such as:

- Public opinion and publicity
- Politics and the UN and International Community
- The reaction of local member states and Regional International Bodies
- Economic and financial considerations

3. The set of remaining options should then be further analysed and narrowed to anticipate how the target defendant and defendant's constituency are likely to react.
4. For each case, the Prosecutor should subject the remaining options to an analysis of four principles or "winnowing" rules. These are:

   (a) Peace first
   (b) Lowest cost
   (c) Simplest to execute
   (d) Least public exposure

5. After setting up a matrix for measuring any option under consideration under the above principles, each option should be further subjected to a risk analysis – an assessment of the risk that the Prosecutor's Office is wrong about the existence of facts or that the outcome sought will come into being.

The uniqueness of our proposed analysis lies in the last two steps whereby options are winnowed according to a set of identified principles or rules. The objective of

this winnowing process is to assist with infusing objectivity and transparency into the charging decisions and management of the case.[14]

Accordingly, our proposed principled-matrix approach (which we will elaborate on in the next section) is as follows:

1. Define legal strategy in the context of the Prosecutor's Office in all its particularities, including its full business setting
2. Examine the Prosecutor's Office objectives, including its needs as well as goals
3. Demonstrate how using the techniques of strategy via a matrix approach enhances comprehensive thinking and clarity essential to sound decision-making
4. Confirm the decision by subjecting it to a further risk analysis so as to ensure that all the circumstances have been carefully considered in light of any uncertainties regarding outcomes

Applying this type of principled-matrix assists in ensuring that the decision reached takes into account the Office's legitimate concerns over the economic and social settings, thus rendering the decision consistent with a wise and statesmen-like purpose and effect.

21.3.1 Defining Legal Strategy

21.3.1.1 Context for Definition

Many kinds of matters brought to the Prosecutor require a strategy. Often, the Office needs a strategy for matters that are technically not "cases." Further, being able to formulate a successful strategy involving the administration of prosecutorial discretion will require years of experience.

It is certainly true that years of experience with what works and what doesn't work can be useful in devising a practical strategy. Yet, what approach should be taken when a prosecutor lacks such experience? It is in precisely these types of situations where the articulation of a context for strategy is crucial including understanding both what a strategy is (as opposed to the tactics that serve a strategy) and what components are required to ensure a strategy's success.

It is also important to note that a successful strategy for a legal problem may also involve non-legal factors such as politics, public opinion, economic trends or danger to investigators and witnesses. While the Prosecutor's Office discussions will no doubt touch on these subjects, there is not a ready context for fitting them into strategy decisions. However, there is a basic method that calls for consideration of these factors at a particular point in the strategy-making process. If the lawyer is

[14]We recognise that the Prosecutor may have further principles or substitute principles for winnowing options. Of course, that is the Prosecutor's prerogative.

not prepared to deal with such non-legal factors, at least the right questions can be raised in a timely manner so that the necessary information can be sought.

21.3.1.2 A Practical Definition of Strategy

Setting a context for a legal strategy requires a practical definition. Analysts of military strategy have published many books and definitions on the subject, going back to the classic by Karl von Clausewitz, *On War,* and even farther back to the great Chinese military strategist Sun-Tzu's *Art of War*. Students of business strategy have also been prolific and observers of political strategy have chronicled the underpinnings of successful election campaigns. In law, however, the literature of strategy has been thin, tending toward tactics that are used in various kinds of cases rather than the strategy process itself. We therefore propose the following process-focused definition:

A strategy is a description of a process. It answers the question: How do we get to there from here within the available time and money resources, including people and expertise?

21.3.1.3 Applying the Definition

The definition gives us a useful beginning for the outline for tackling strategy problems (Fig. 21.1).

First, we have to understand what "there" is.

What does the Prosecutor's Office really want as an outcome in this situation? Is the outcome that the Office wants the same as the outcome that the Office needs? Should we think about trying to help the Prosecutor's Office sharpen or modify the vision of its desired outcome? Developing a good understanding of the desired outcome or the "there" is essential to any successful strategy. While the mission of the ICC is key to defining "there," there is also a danger in the prosecutorial setting to define "there" in terms of winning cases. Therefore, in the highly charged environment in which the ICC finds itself, the Prosecutor should continually direct

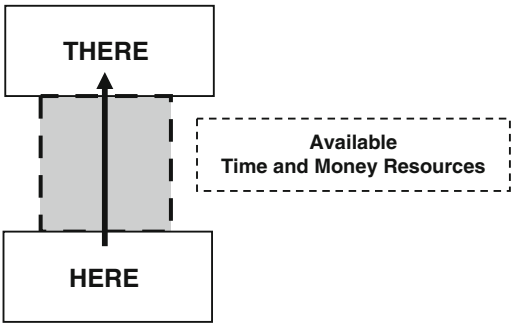

Fig. 21.1 Conceptualising to there from here

his lawyers to the broader understanding of the Office's mission – to develop the rule of International Criminal Law with all the benefits of deterrence that will likely follow.

Second, we have to understand what "here" is.

What are the salient facts and relevant law that define the ICC's current situation? The facts and law usually fall into two categories: that which we have in hand at the present time and that which we would like to have. In developing a legal strategy, it is often necessary to work with what is in hand because important facts may not be known to the ICC as an institution and developments in the law are usually not within one's control.

Third, we have to appreciate the constraint of the "available time".

Of all the dimensions of strategy, time is unique for being un-improvable. Use it or lose it. Therefore, in order to even have a chance at success, we must understand the time period within which the problem needs to be solved. Time is a strategic dimension often too little understood and consequently too little valued. A strategy will not be successful if it takes so long to implement that it is overtaken by events or if another's strategy successfully alters the context of the dispute.

Fourth, we also must appreciate the constraint of "available resources".

The "available resources" can make some strategy options impractical because the ICC simply cannot afford to implement them. This category includes: cash costs (for example, legal fees, expert fees and information and technology services); overhead costs (some countries have internal resources for fact investigation, working with the prosecutor and other aspects of dispute resolution, but diversion of internal resources always entails an overhead cost because these resources would otherwise be used in other matters); and indirect costs (for example, employee pensions, record keeping, warehousing and management costs may increase).

21.3.1.4 Differentiating Strategy from Tactics

Tactics are usually defined as devices for accomplishing a strategy. Tactics involve the use of instruments of power in action. Tactics dispose but Strategies propose. Once a strategy is established, tactics may be the details of the plan, the logistics for supporting the strategy, the rules of the game or the manoeuvres along the way. In military terms, "take that hill" is a tactic; the "race to Baghdad" is a strategy. An example in the legal context may be: "get a preliminary injunction," a tactic, and "stop my competition from telling lies about me," a strategy.

In dealing with strategy, lawyers need to avoid getting bogged down in the details which usually are tactics at play. Discussions with the Prosecutor usually quickly descend to a consideration of tactics as that is the level at which most people feel comfortable. The individual assistant prosecutors need to be able to direct the Prosecutor to the specific ends needed to formulate a strategy and to avoid pursuing detailed consideration of tactics until after the strategy has been formulated.

21.3.2 The Prosecutor's Role in Legal Strategy for the ICC

Normally the decision-maker with respect to legal strategy is the ICC itself through its Pre-Trial Chamber. However, deciding on strategy is different from giving advice about strategy. Because the individual Prosecutor and assistant prosecutors are advisers, the strategy work involves the following basic elements:

Deputy Prosecutor's communication with the Prosecutor and in turn the Pre-Trial Chamber: Communications, whether written or oral, must be clear and easy to understand. Legal jargon should be kept to a minimum and legal terms, when used, should be defined or explained in plain English. A key factor is maintaining the Prosecutor's confidence while working through the problem. Some of what is necessary to developing sound strategy might be interpreted by the Prosecutor as "not being on my side" or "not being committed to help me" unless attention is paid to good communication. So part of this discussion involves a consideration of how a strategy should be presented to the Prosecutor and in turn, to the Pre-Trial Chamber.

Common understanding of the facts: The members of the Prosecutor's team must have a common understanding of all the available, relevant facts and the areas where relevant facts are not currently available. The individual prosecutor needs to be sure that the Prosecutor understands that new or additional facts may change the strategy and that the costs and benefits of obtaining additional facts are carefully considered. An individual prosecutor's normal instinct is to ask for more facts; a Prosecutor's normal approach is to get a strategy based on what is currently known and to think about any changes later. A good prosecution team member will usually accommodate the Prosecutor and articulate appropriate caveats.

Identifying options: In any given prosecution, the options might be: prosecute on a variety of counts (particularly when it might lead to the development of new law); prosecute on only a small number of counts; set up a behind-the-scenes plea agreement (this can include: serving time, turning states' evidence, returning ill gotten gains, confessing to judgment or bringing in third party mediators to negotiate removal from power); or "do nothing" but then closely watch the processes of any Truth and Reconciliation Commission (TRC) that might exist or other local or regional International Tribunal prosecutions. How can the Prosecutor's team make sure that it does not miss important options when it is set in such a web of political actors?

21.3.2.1 Brainstorming Options

Before narrowing options and deciding on a strategy, it is always a good idea to lay the widest possible range of options on the table. Creativity in thinking about options is the hallmark of a great lawyer in any field of expertise. Members of the legal team should be encouraged to think "outside of the box" and to not jump to conclusions about where the strategy will ultimately go. This is one of the hardest

things for many lawyers to do because legal training tends to make lawyers put knowledge in silos without creating many channels between them.

When developing options, either as a group or solo exercise, the lawyer should not be concerned about the ICC's preferences or likely reactions. Not all of the options developed by the strategist would necessarily be communicated to the Pre-Trial Chamber. One of the lawyer's tasks is to conserve the ICC's time while preserving the Chamber's decision-making prerogatives. Some options might take considerable time to explore with the Prosecutor but might not be very promising at all, compared to other options that appear more practical under the circumstances. However, when developing options, it is always a good idea to keep a list. Options that are at first rejected may be revisited if circumstances change, as they often do.

The selection of the most promising options is generally tackled by eliminating the least promising options first, then analysing the remaining options more systematically to assess relative risk. Where possible, visual methods should be used to compare options. Visual methods help to record views, rank factors against one another and summarise a necessarily subjective process in a useful way. One visual method that is relatively easy to implement is a simple matrix. The strategy framework which is set out later in this discussion incorporates two such matrices.

21.3.2.2 Consideration of the Other Side's Needs and Interests

The subject of assessing an opponent's needs and interests frequently occupies the attention of scholars and practitioners occupied with negotiation and mediation who have produced a useful literature on these subjects.[15] The strategist is interested in the other side's needs and interests, primarily to assist the strategist in assembling the best options into a process. Fisher and Ury have suggested a formula that works well: Ask why? Put yourself in the opponent's shoes and ask why they are doing (or did do) what they are doing (or did). What could be the desires, concerns, fears or hopes behind their actions?[16]

In this case, the non-strategic Prosecutor may want to hear only one answer because of the belief held that the actor is a war criminal who committed war crimes primarily out of his own need to get power. The strategic Prosecutor on the other hand would consider other possibilities. For example, was the rebel leader himself a child soldier or was the rebel leader desperate for recruits and had no other options? The assessment of the other side's needs and interests helps the strategist and will be a factor in comparing options and deciding how far a Prosecutor should go in trying to deal with the situation.

[15]For example see, R. Fisher, and W. Ury, *Getting to Yes: Negotiating Agreement without Giving In,* 2d ed. (Penguin Books, 1991) [Fisher and Ury]; See also P. J. Zwier, and T. F. Guernsey, *Advanced Negotiation and Mediation Theory and Practice* (NITA, 2005); See also J. W. Cooley, *Mediation Advocacy,* (NITA 1996).

[16]Fisher and Ury ibid.

The options could be many and varied. Still, it is important to be as open-minded in this first step of the process in order not to be too constrained by typical legal thinking. Creativity requires it.

On the other hand, creative brainstorming can also set up a number of potential pitfalls. Those pitfalls are initially related to the horizontal and tertiary factors that can sink too narrowly focused strategies. We propose that all options under consideration must be weighed against their effect on any peace process, including: the stability of the post-conflict peace; the jurisdiction of local courts and tribunals; the safety of investigators; and the safety of witnesses. Moreover, the Prosecutor must carefully consider the publicity and public opinion effects of each option as well as the factors of international politics, regional political actors, financial and economics.

Ranking important factors: Nearly every legal problem is affected by numerous factors – facts, law, international political conditions, public opinion and similar matters. Not every factor though has the same importance, thus ranking factors is a necessary skill. For example, some facts are very important in developing strategy and other facts might fall into the "nice to know" category. An early focus on the important, but currently unavailable, facts will allow the strategist maximum flexibility.

Developing and comparing options: It is usually not a good approach to strategy to ask: "What is the answer?" A better approach is to ask: "What are the options?" and to range as far afield as imagination and creativity will allow in identifying them. Strategy is the definition of a process. The best options are used in shaping the process. In most cases, there is not one simple answer; the strategy outlines the opening move, subsequent moves if the opening move is not successful and an end game if earlier moves have not achieved the desired outcome.

21.3.2.3 Thinking in 360 Degrees

Developing a successful legal strategy for an important prosecutorial problem usually demands an open mind – a disciplined thought process that minimises the possibility of overlooking essential factors and a willingness to look beyond the obvious. The thought process in beginning to examine the options for a legal strategy can be captured in a 360 degree analogy (Fig. 21.2):

- Define clearly what you are directly looking at – the "there" you want to reach. Writing down the objective is often a way to zero in on the ICC's expectations.
- Experiment with alternative versions of "there" to arrive at a simple statement of the objective.
- Avoid adjectives and adverbs as those are "colour" words that often mean different things to different people.

Where then is the ICC with respect to the strategy elements – to *there* from *here* (includes *law* and *facts*) and taking into consideration, *time* and *money resources*?

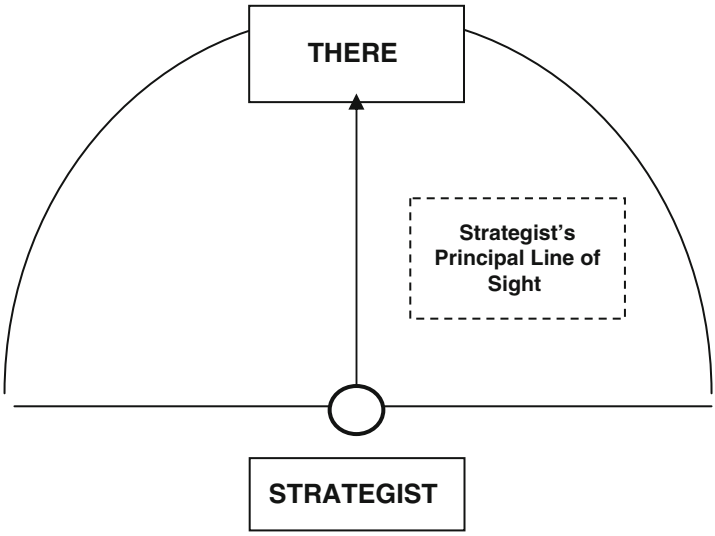

Fig. 21.2 The 360 degree analogy

We turn to this question with reference to our hypothetical: the potential prosecution of a rebel leader who ends up on the victor's side of a civil war in an African country.

There: What Will the ICC as an Institution Regard as a Satisfactory Outcome?

The ICC may be focused on obtaining a successful prosecution of a rebel leader on charges of recruiting child soldiers in order to demonstrate its even-handed approach to deterring the use of child soldiers, whether the actors were winners or losers. However, the strategist considers the broader question, "what does successful prosecution mean?" and "what if the prosecution loses?"

The strategist might also define a satisfactory outcome as "over time, showing even-handed prosecutions, but also over time, deterring crime while keeping the peace in a particular country." Achieving the maximum outcome in the short run might end up destabilising the country and in fact, could lead to a return of other civil war forces that may have acted with impunity in recruiting child soldiers, and return to doing so. Thus there is a considerable gap between the possible maximum short-term legally-defined outcome and a potentially satisfactory more general outcome.

How should the strategist go about helping the Prosecutor's Office focus in defining a satisfactory outcome? Here the following points must be made:

- Defining a satisfactory outcome is an internal goal; it does not mean that the Prosecutor's Office will not achieve a better outcome, or even the maximum outcome if circumstances arise (for example, in a negotiation) where that is

practicable. So a satisfactory outcome might be to have the defendant admit in some meaningful way to have done wrong and that he feels sorry for what he has done – that along with a public show of contrition, including the payment damages, or setting up of a compensation or educational fund which might provide for real deterrence. However, carefully defining the internal goal is critical because it, in turn, will be a benchmark against which various options are measured. If the internal goal is set too high, productive options may be rejected.

- A satisfactory outcome depends on the context. As the court's prestige increases and resources increase, a satisfactory outcome may be much closer to the predicted outcome in court.

This is a familiar problem that arises in many legal contexts: does reaching for the best (or a better) outcome reduce your chance of getting an acceptable outcome? For a Prosecutor who is risk-averse, he will usually tip the balance in favor of pursuing only an acceptable outcome. For a nation-state prosecutor with substantial financial reserves and a willingness to take risk, the balance might be tipped the other way. The ICC Prosecutor must normally start on the more conservative side in order to help the ICC make a sound assessment as to the strategy to be followed.

Here: What Is the Current State of the Law?

In order to assess the current State of the Law, it is first necessary to identify the kind of case being dealt with. In general terms, if it is a case involving a war crime, success at trial, as with any crime, requires proof of the elements of the crime.

Therefore, the crime of the purposeful conscription of child soldiers must be broken down into its elements and examined for potential difficulties of proof. The actor is charged with conscripting child soldiers and then drugging them and so terrorizing them as to turn them into psychopathic killers, capable of the most brutal of acts of war – including the killing and rape of innocent civilians.

What are the elements of such a crime?

- Knowingly conscripting children
- Manipulating them into committing war crimes against civilians
- Failure to take steps to punish those who engage on behalf of the rebel movement – theory of superior responsibility

What are the defenses likely to be put forward?

- *Ex post facto* law. This area addresses defenses and arguments such as the definition of who is a child for the purpose of this crime was arrived at *after* the suspect is alleged to have engaged in the activity. Additional questions might include: Is their proof that a particular child actor was 15 at time of conscription?; What if he was 16, the age of adulthood according to the law of the nation

state at the time?; What if the child volunteered?; What if the particular child actor was not manipulated or when the child committed the act, the child was over 21 years of age? It might also raise equity arguments: what are the equities if, at the time of the alleged acts, the government opposition group was using child soldiers in similar manner and the rebel side was only using the same tactics. Furthermore, what if the war occurred over a 13 year period and/or witnesses are hard to come by, since the child soldiers often killed all the witnesses?

- The rebel leader might also raise that he did not know: (1) that the children were being conscripted rather than that they volunteered; (2) manipulated; or (3) that they would commit crimes against humanity.
- As to the use of the superior responsibility theory – the rebel might argue that he either had no knowledge of the practice or he had no authority over the particular rebel leader in charge of the operation.

What is the likelihood that this law is "developing?"

One might conclude that the humanitarian law regarding the conscription of child soldiers has now been settled because of UN declarations on the subject. Nonetheless, actual prosecution for these crimes has never been successfully conducted.

Here: What are the relevant facts?

First, the factual examination focuses facts familiar to any lawyer – who is the target and what did he do (i.e., who, what, where, when, why, and how). In this regard the following questions may be canvassed:
Who is the target?

- History of rebel leader, including where he is now

Who is the opponent and are they still politically active in the region?

- Are they active in the nation state's politics?
- Do they have a constituency?
- Who is in their chain of command with respect to our issue?

What has happened to date?

In a case where dates or chronological order of events are likely to be important, it is helpful to construct a time-line that contains all the dates that are or may become important. A time-line can be an important visual tool and can help the strategist and the ICC obtain a clearer overview of the situation.[17]

Second, think more broadly about what could be relevant. For example, what is within your horizontal line of sight, i.e., what you can "see" from the currently

[17]There are inexpensive specialised software packages that create timelines. Alternatively, a presentation graphics program can be used.

available facts that might possibly affect the options you want to consider (Fig. 21.3).

A horizontal approach incorporates additional factors in the strategist's secondary line of sight. With respect to the ICC, this would include consideration of the following factors:

- The effect of any indictment on any peace efforts
- Other courts/tribunals with potential jurisdiction
- The safety of its investigators
- The safety of witnesses who might be called

Third, think about what might be going on at present but entirely hidden from your view. One way to organize analysis here is to identify these tertiary factors through recourse to the mnemonic PPREF, which stands for Publicity and public opinion, Politics and the UN, Regional Regulators, Economics, and Finance (Fig. 21.4).

The PPREF factors may not always occur in this order of importance and therefore they may need to be revisited from time to time. Here's how they work:

- *Publicity and public opinion*: This factor has a very broad reach for an organization like the ICC. It includes: possible interest in the matter by the media; how the public (certain associations of member states like ECOWAS in the case of East Africa, individual member states, NGOs, advocacy groups and opposition groups) might react; and the trickle-down effect that this factor may have on other PPREF factors. Although publicity and public opinion are closely related, they are not necessarily proportional. The news media may care about a subject and the public may care not at all.

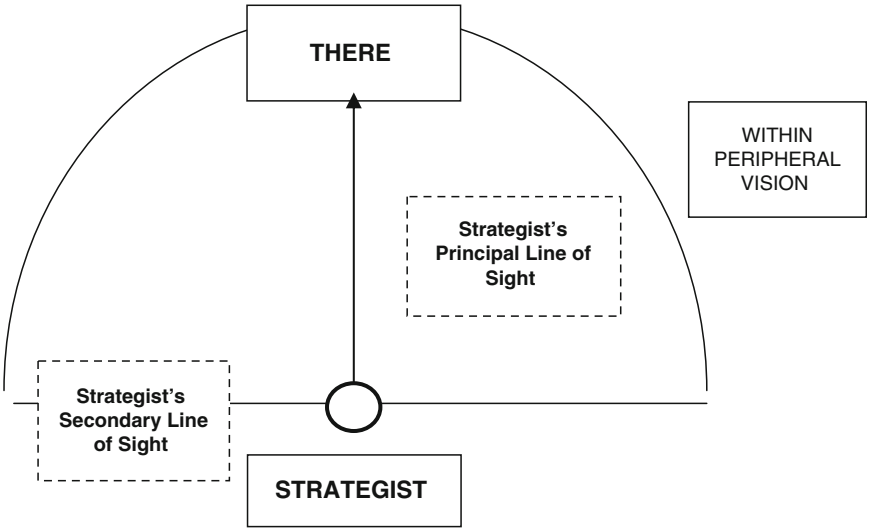

Fig. 21.3 The 360 degree analogy incorporating secondary factors

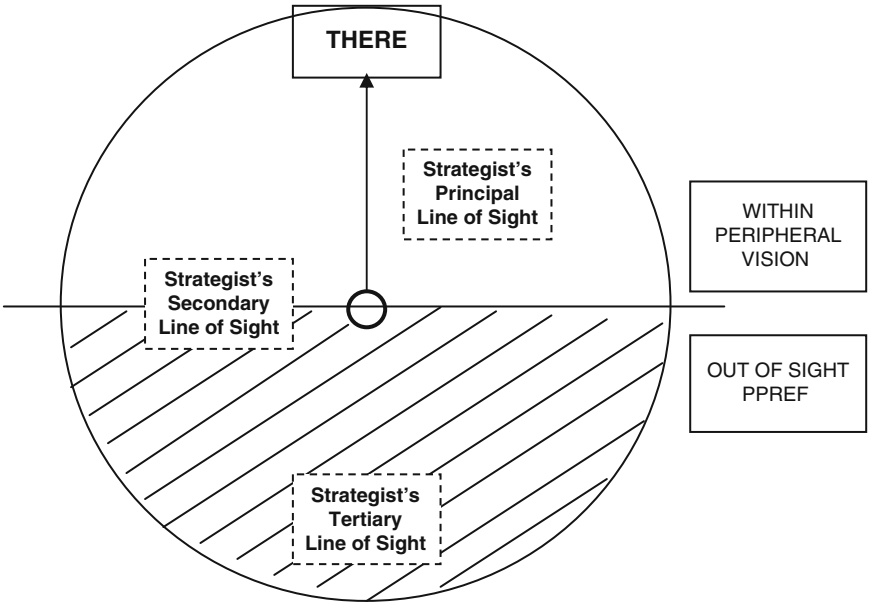

Fig. 21.4 The 360 degree analogy incorporating tertiary factors

- *Politics and the UN*: This factor involves an assessment of two things: (1) is there any likely UN legislative solution to our problem that could be used for us or against us?; (2) are there any UN ambassadors likely to take an interest in this matter and, if so, is that interest likely to be expressed or manifested for us or against us? Politics affects many international criminal matters more than most law-focused ICC actors realise. The informal web of connections between UN representatives and officials and NGO donors, and the connections between the UN and international politics at all levels may have a great deal to do with the outcome of a specific legal problem.
- *Regional association actors*: This factor includes the association of African States, ECOWAS, but also organizations that may be principally focused on world health. Are there any trade or world health regulatory factors that could be used for us or against us? If regulators took an interest, what would they likely do?
- *Economics*: This factor arises out of the international and local economy where the suspect is acting and includes things like private and national economic actors with an interest in the economy where the suspect may have support. The economic outlook often affects the time factor in laying out a strategy. If economic factors are likely to change, then our time horizon may be lengthened (by favorable factors) or shortened (by unfavorable factors).
- *Finance:* This factor primarily includes the World Bank and any interest it might have in the suspect, but also includes any banking relationships or funding interests that may be financing the suspect's operations and other financial

impacts unique to the opponent. An effective strategy might include financial incentive and disincentives being brought to bear, much in the way a trade embargo might be used to affect a national actor.

No single lawyer in a Prosecutor's Office is expected to know everything about all these factors and no list such as this one can encompass all the factors that might foil an otherwise successful strategy. However, these are the unexpected influences most likely to rise up and thwart a strategy that is successful in all other respects. Anticipating the unexpected is one of the hallmarks of a good strategist.

In addition, the ICC will value a Prosecutor's Office that can think beyond the realm of the strictly legal and can appreciate the broader factors affecting its survival. A lawyer who knows nothing more about the PPREF factors than to ask the necessary questions is likely to be much more valuable in a strategy discussion than the lawyer who has only mastered the relevant law down to its tiniest details.

Time: What Is the Time Frame Within Which This Problem Has to Be Solved?

The time frame within which this problem *has to be solved* relates primarily to other cases being prosecuted, the ICC's financial situation and whether the new government is secure and the political situation stable. It is not in the interests of the ICC to solve this problem satisfactorily if it becomes bankrupt by the time that solution is reached, or if the country involved is made worse off by the indictment. In addition, as a practical matter, if the country has a Truth and Reconciliation Commission in place, the ICC might give that process a chance to work.

Money Resources: What Is the ICC Willing and Able to Pay for Such a Prosecution?

What is your estimate of what the ICC is *able to pay*, given the situation it is in? How do you go about making this kind of estimate?

- How is the UN budget structured? Should you check the UN's ability to provide other special funding? Is there a special task force on Child Soldiers that might be recruited to do some of the investigative leg work on the case?
- Does the ICC have a revenue stream available for preliminary problem-solving? On a business level, for a Court to be profitable, it seeks return of profits to fund other prosecutions. Yet victims are most often in more need of the funds, so it is unlikely for the Prosecutor to secure funds from the targets of their prosecution. However, aggrieved and complaining parties might be willing to pay contingencies in special circumstances.
- What does the ICC expect the time horizon to be? The ICC may have other strategic planning documents that set out targets regarding the number of prosecutions and for certain types of crimes.
- How much of this problem is the ICC delegating to the Prosecutor?
- What is a satisfactory outcome worth?

Remember, strategy answers the question: How do we get to there from here within the available time and resources? Assume that, at least for now, you are satisfied with your understanding of the "there," "here," "time," and "money" factors as above. What is the answer to the "How do we get from" part of the question?

To answer the "How" question, the strategist needs to develop possible options, discard options that are too risky or not viable and shape the remaining options into a strategy that begins with the "opening move" and concludes with the "end game."

21.3.3 Applying the General Rules to Winnow Down the Available Options

The process of developing options should yield many more options than can be usefully shaped into a process for solving the problem. Winnowing down the options is important to conserve the Chamber's resources and to make the strategy manageable. As described earlier, there are four general rules available to help in this process of discarding the worst of the options:

- *Peace first*: It might be presumed that the ICC likes their lawyers to be warriors, but "peace" options should always be considered thoroughly before any "war" options are used. This comes under the general principle of "Don't make the problem worse."
- *Lowest cost:* The lowest cost option deserves the hardest look. The cost of legal matters tends to escalate and cost estimates tend to be optimistic. Most not-for-profit actors would rather spend the marginal dollar on sure things or on efforts where the risks are shared.
- *Simplest to execute:* Execution of legal strategies is always risky, especially where the court lacks extensive experience in managing prosecutions and as such are likely to be difficult for the Prosecutor to control. The option that is simplest to execute is often the least risky.
- *Least public exposure:* At least at the beginning, the ICC should operate largely out of the glare of public opinion until it can establish a set of processes that show its legitimacy. The ICC should not ignore or underestimate the costs of publicity and adverse public opinion in legal matters. Avoiding public exposure where possible avoids a risk that may have unknown proportions.

21.3.3.1 A Matrix Exercise

When applying the general rules for comparative purposes, using numerical ratings rather than descriptive words usually yields a better, more practical result. What one person means by "low" may be quite different from what another person means by the same word. However, if a scale of 1–5 is applied, for example, with 1 as the

lowest score and 5 as the highest, the total score is usually a good reflection of the comparison.

A matrix listing the options on the vertical axis and the general rules on the horizontal axis will permit ready comparisons. Use numerical ratings ranging from 1 to 5 or 1 to 10, depending on how many options you have. If there are relatively few options, a 1–5 scale should suffice. In this case, we have 12 potential options, so a scale of 1–10 might be better.

Each option is ranked relative to each other option with respect to one of the general rules. Using scores in a matrix is not to suggest that there is a "right" total score; only that a rough scoring can assist in weeding out some options instead of others. The purpose of the matrix is to answer the following question: "Compared to what?" So, for example, with respect to the general rule favoring "least adverse public exposure," the question is which of the options is *most* likely to generate adverse public exposure. Getting a conviction is a very public option, so one might give it a low score in this regard. Then the question is what option is the *least* likely to get public attention. The informal mediation and informal persuasion options tend to be very private if properly handled and therefore seem less likely to draw adverse attention than the other options. After this, other options are compared to the best and worst and among themselves. The question is whether this option is more, less or equally likely to generate adverse public exposure than some other option.

Table 21.1 is an example of such a matrix. A rating of 1 indicates no compliance with the general rule. A rating of 5 indicates very good compliance with the general rule. Higher total scores indicate better options.

Table 21.1 General rules and options matrix

Options	Peace first	Low cost	Simple execution	Least public exposure	Total score
Broad indictment	1	1	1	1	**4**
Narrow indictment	1	4	5	3	**13**
Prosecution through existing International Criminal Court	2	5	4	3	**14**
Plea deals					
D submits to jurisdiction and serves time	3	1	1	2	**7**
D shows contrition to Truth and Reconciliation Commission and pays fine to Coalition to Stop the Use of Child Soldiers	3	5	5	4	**17**
Secure agreement to remove from politics or contribute to exposure by providing evidence of crime to other authorities	1	4	4	1	**10**
Rely on TRC	6	5	5	4	**20**
Provide evidence and assistance for prosecution by Nation State Criminal Processes	9	6	7	8	**30**
Do nothing	10	10	10	8	**38**

Using the matrix, the team should discuss and debate the relative scores. This is a way to examine assumptions, compare ideas, and stimulate creative thinking about the problem. In simplified form, the discussion might be as follows:

- *Broad indictment*: Seeking a conviction is not a peaceful solution, in particular where someone is charged with a broad array of high crimes and misdemeanors: mass murder, rape, genocide, conscription of child soldiers; it is not a low cost solution; it is rarely simple to execute because the client has control of only its part of the process; there is a great deal of potential public exposure, particularly where electronic filing is used because all records are not only publicly available but completely searchable.
- *Narrow indictment:* Narrowing the indictment to one charge can focus the investigation and lower the costs, but raises the risk that the charge will not stick. In addition, it still means an indictment for a violation of criminal law. It risks insulting the nation state for its failure to enforce its own criminal law and risks alienating supporters of the target, or similarly situated persons, perhaps emboldening them to move to protect themselves by grabbing for power.
- *Prosecution through partnership with existing International Criminal Court:* Where this option exists it should be explored. Does it fit the specialty court's jurisdiction and priorities? Is there a perception of unfairness in that court that could be remedied by this investigation? Does that court's current investigations contain evidence (witnesses and forensics) that could be enlisted in the prosecution, lowering costs and risks in the process?
- *Plea deals*: It will initially be hard for the ICC to be able to justify plea agreements with those charged with violating its enabling statute. After all, these are not trivial matters or insignificant crimes. Still it is important to consider.
- *D submits to jurisdiction and serves time:* Wouldn't this be nice – a confession of guilt and a real act of contrition by serving jail time?
- *D shows contrition to* Truth and Reconciliation Commission (TRC) *and pays fine to Coalition to Stop the Use of Child Soldiers*: The obvious problem here is that the target may not have profited from his acts in a monetary sense.
- *Secure agreement to remove from politics or contribute to exposure by providing evidence of crime to other authorities*: This option is not easy to execute. It will involve significant monitoring and enforcement risks.
- *Rely on TRC:* This has the prospect of being a peaceful solution and could be the best possible outcome depending on willingness of the actor to participate, the sincerity of the confession and the acceptance and reconciliation that comes from the victims and the families of the victims.
- *Provide evidence and assistance for prosecution by Nation State Criminal Processes*: This option might arise if the TRC process fails. Before giving up on the member state's own criminal process, it might be best for the state to act. But it is unrealistic to expect that its court will be able to enforce its own laws, when those laws may not include prohibition against the use of child soldiers.

- *Do nothing*: Doing nothing is a peaceful option. It is a low cost option because the Prosecutor's Office is basically waiting to see if anything further happens. Of course this assessment may change if the damage is ongoing (for example, Sudan) or if the local community suffers the terror brought about by the apparent immunity of the actor (for example, Zimbabwe and Rwanda). Still, it is simple to execute and has low public exposure.

This comparative analysis suggests that indicting our hypothetical suspect based on what we now know is our "worst" option and therefore should be the first option to be discarded because of the existence of other more viable options. This will almost always be the case at the beginning of the ICC's work. Seeking a conviction is expensive and risky. It may be the end game of the strategy if the ICC absolutely must reach an objective that ultimately can be had only by successful conviction. This is most likely not the case here. Why then go through this process? The answer is simple. It can demonstrate to the Pre-Trial Chamber the good institutional reasons for its strategy. It will also establish a good basis for distinguishing future prosecutions in the event of increased resources or changing situations of on-going harm.

The options of negotiated plea deals might be discarded at this stage as well, as it will be significantly complex to execute, monitor, and enforce.

The matrix exercise has allowed the strategist to discard four or five of the options.[18]

21.3.4 Focus on the Risk of Being Wrong in Order to Select the Best Options

There may be no one "right" answer as to the strategy to be followed; however, there is almost always a right answer with respect to the relative amount of risk that is involved with a particular strategy option compared to other available options.

Most inexperienced prosecutors are too optimistic in making judgments about risk in a legal strategy situation. For that reason, it is a good idea for the prosecutor to (1) think about the downside; and (2) express opinions in terms of numbers, not in terms of words such as "good," or "pretty good," or "likely." Using numeric values ensures that the participants in the development of the strategy all understand each other.

Looking at our four strategy definitional elements from the risk of being wrong perspective, the following should be considered:

[18]In the words of that great sage and songwriter Kenny Rogers, "Every gambler knows, The secret to surviving, Is knowing what to throw away, And knowing what to keep, 'Cause every hand's a winner, And every hand's a loser. . .."

- *Here:* With respect to the current situation, how much risk is there that we are wrong as to the facts? There are certain facts that are key to a particular option being the right route to the desired outcome. What is the relative risk that we are wrong in what we now know?
- *There:* In this case, assume the ICC's objective is simply having future warring parties not use child soldiers. With respect to that desired outcome, how much risk is there of not getting to that outcome in following a particular option?
- *Time:* How long is the option likely to take? Is this option within the Prosecutor's available time? In a situation such as this one, where the time constraint may be flexible, ask what is the relative position of each option with respect to the time it might take to get to a resolution. Since a Truth and Reconciliation Commission process is usually on a two year time horizon, it usually will produce quicker results, or at least more information, if it is being operated efficiently and effectively.
- *Money resources*: What is the option likely to cost? Is this option within the ICC's available money? What is the relative risk with respect to the amount of investment that will be required by the Office to carry out this option? This factor includes the amount of legal research and factual investigation potentially needed to ensure that an option is either available or executed correctly.

Create another matrix and write out a comparison of the remaining options including their respective scores. This matrix assesses fewer options, so its ratings can be on a simpler 1–5 scale. You may not get the numbers right in the absolute sense but you probably will get the relationships among the options right. This is also a good vehicle for lawyers working as a team to pool their views. It also provides a good outline for explaining a strategy to the client. While the matrix itself is not often used with the client, having worked through the matrix, the lawyer's explanation is usually more organized.

Table 21.2 is a sample risk matrix. A rating of 1 means relatively little risk; a rating of 5 means quite a lot of risk. Low total scores indicate better options. Note

Table 21.2 Risk matrix

Options	*Here* risk that key facts are wrong	*There* risk that outcome is not reached	*Time* risk as to amount of time	*Money* risk as to investment required	Total risk
Prosecution through existing International Criminal Court (14)	4	3	4	1	**12**
Do nothing (38)	1	4	1	1	**7**
Plea deal-D shows contrition to TRC and pay fine to Coalition to Stop the Use of Child Soldiers (17)	4	4	5	3	**16**
Rely on Truth and Reconciliation Commission (20)	3	2	2	2	**9**
Provide evidence and assistance for prosecution by Nation State Criminal Processes (30)	3	5	4	5	**17**

that this risk matrix works in the opposite way (low score means better option) than the general rules matrix (high score means better option). The reversal of the scoring helps to stimulate careful thought.

Again, using the matrix, the team should discuss and debate the scores. Such a discussion might proceed as follows:

- *Do nothing*: There is no commitment to any particular facts in the "do nothing" option, so there is relatively little risk with respect to the facts being wrong. There may nonetheless be a higher risk of a bad outcome, however, if a totally passive option is selected. No time or money will be expended in this option (except to monitor the situation), so there is basically no risk of being wrong as to those factors.
- *Plea agreements with time served or sanctions*: The risks with respect to pre-indictment persuasion seem relatively low. While there is some risk that this option will not be effective in obtaining a confession, an agreement to serve time, or payment of a fine, at least in this instance, the harm is not ongoing. Still, even if successful, the deterrent effect is not very great. A skillful effort at persuasion probably presents less risk than doing nothing, and probably presents less risk than using other courts, in which the two sides confront each other in a framework designed for disputes. The time and money risks are lower than other options. Informal persuasion would not necessarily involve legal time.
- *Truth and Reconciliation Commissions – mediate informally*: In mediation, there is more commitment to a particular version of the facts and therefore more exposure if the facts are wrong. Informal mediation is a low risk option with respect to a bad outcome because a skilled neutral party tries to help achieve a workable outcome for both parties. The time and costs of mediation are usually well-defined because the process is short and participants are limited.
- *Provide assistance to Nation State Court*: Prosecutorial assistance to another court may be an overlooked option for the ICC. (The US experience of co-operation between state and federal officials suggests such efforts can work well.) Of course, there is still the risk that the Nation State cannot carry out its prosecution, especially where individual prosecutors may be loathe to prosecute winners who may still exercise political power.

It is important to emphasise that there is no magic in any particular rating. The effort is to assess relative risk when picking among viable options. The matrix provides a vehicle for asking, "Is this option more risky than others in respect of this single factor?" A low number means *less* risk.

For example, with respect to the risk that the time estimate is too short, the options of relying on the TRC or a Nation State Court presents significant risks because of the uncertainty that its processes will work and thus presents the most risk as to that particular factor. For that reason, the strategist might look first to the remaining options when fashioning a strategy.

21.3.5 Assemble the Best Options into a Process

Strategy is a process. The process identifies a starting point and, if the actions proposed as the starting point do not achieve the defined objective, then the process continues with a second move, and so on. For this reason, the strategy may incorporate a number of the available options.

21.3.5.1 Identify the End Game

In each strategy, it is important to understand the end game. This is the point beyond which, at present, it is not worth going. The facts may change and, if they do, the end game may also change.

Many prosecutors assume that securing convictions is the end game with respect to most disputes. In fact, securing convictions, at least early on, is an extreme remedy and usually not worth its cost. In seeking convictions, the prosecutor loses control of a large segment of the process. Much of what happens, and how long it takes, is dependent on the moves of the opponent.

21.3.5.2 Identify the Opening Move

The best opening move is often the least aggressive, particularly where there are facts yet to be gathered and verified. Many prosecutors like to start from a position of strength and define this as an announcing of a broad indictment. However, this should be assessed carefully against the opponent's needs and interests. A threat of conviction may get the opponent thinking that he has little to lose in terms of his future and a contest may be created where a more sophisticated approach might have avoided such a contest in the first place.

In this case, one option is to do nothing, waiting to see if the Truth and Reconciliation Commission produces any results. A wait-and-see option, if viable, is a legitimate opening move.

21.3.5.3 Array the Other "Best" Options Between the Opening Move and the End Game

The process can be represented graphically as a tree. The opening move will either work or it will not work. If it doesn't work, the strategist places a second option as the second move. That option will either work or it will not work and so on. The tree identifies each option, and shows the path to be followed if the options work or do not work (Figs. 21.5 and 21.6).

For example, if the strategist recommended that the opening move in the process should be doing nothing, that might work if the TRC process works, but the TRC

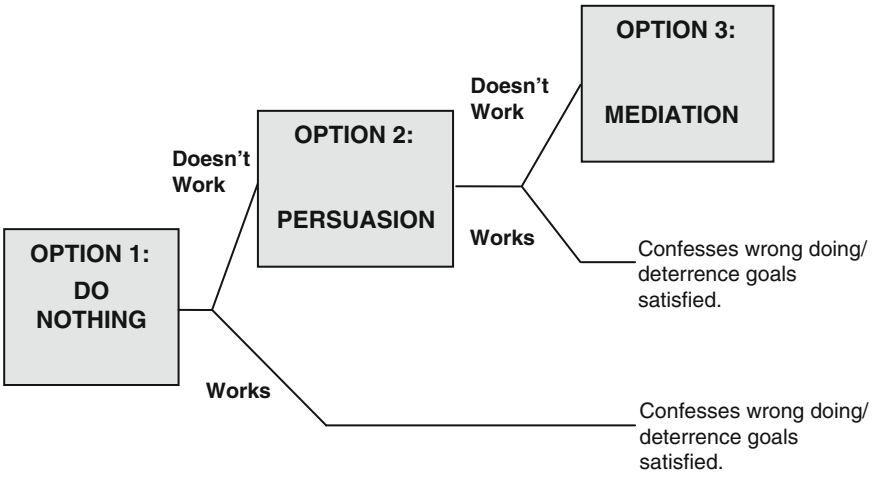

Fig. 21.5 Options tree 1

may need a little help if it looks like the defendant won't make it there on his own. If it doesn't work, the strategist's next step in the process might be some form of informal persuasion and co-operation with the TRC. If that works, that ends the matter. If that doesn't work, the strategist's next step in the process might be, for example, some form of assistance to a specialty court.

The process can have concurrent activities. In the example provided below, the strategist has recommended that the ICC pursue steps beyond assisting a specialty court and has used the broader definition of a satisfactory outcome (contrition and act sufficient to show sincerity) to suggest a more creative option.

If the specialty court lacks the resources or the will to pursue the case, the strategist might suggest that someone from the ICC approach the defendant through a mediator with a creative plea. The strategist might elect to attempt this solution if the first three fail and if the ICC becomes a target of criticism for uneven and political prosecutions.

21.3.6 Communicate the Strategy to the Prosecutor and to the Pre-Trial Chamber

Part of the success of any proposed strategy is the clarity with which it is communicated to the Pre-Trial Chamber and the discipline afforded in the discussion of alternatives. Keeping these aspects in mind should help make the ICC more transparent and assist in establishing a principled defense of its prosecutorial discretion.

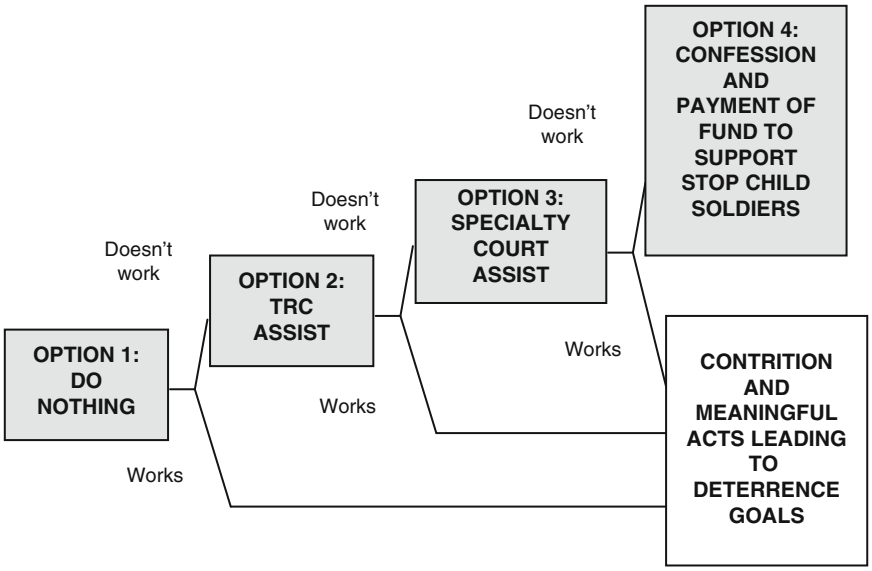

Fig. 21.6 Options tree 2

21.4 Conclusion

Implementing tools of legal strategy can not only lead to wise decisions but can also lead to more comprehensive considerations of a jurisdiction's political setting such as the ICC. We hope we have demonstrated not only how a legal strategy process can work but have also demonstrated that a transparent and principled analysis can produce defensible charging decisions.

In the process, we hope we have also made the case for a jurisdiction to take into account its legitimate interests as an institution (in the way it carries out its mission, its budget, the risks to its actions) and the alternatives to providing deterrence and even retribution when exercising its prosecutorial discretion.

A legal strategy approach can be a powerful tool in understanding any "real politic" process in Court. In the context of the ICC, its use demonstrates how a conservative and "go slow" approach is justifiable in light of the precarious political context. At the same time, it demonstrates that there is room for creative problem-solving approaches which can further its mission and provide "satisfactory" solutions to the problem of deterring future criminal actors. Strategy provides a process to continually examine the ICC resources, pick its prosecutions in the light of its mission and can lead to the development of alternative means to achieve its objectives.

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