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Editorial Note

Special Issue "Law Research Network of the Council of European Studies"

The Council for European Studies (CES) held on June 27-29 of 2023 the 29th International Conference of Europeanists on the theme of *Europe's Past, Present, and Future: Utopias and Dystopias* at the University of Iceland in Reykjavik, Iceland. As an active part of the Council for European Studies, the Law Research Network participated in the Conference with many significant contributions regarding several legal issues. The present special issue consists of some of the most interesting contributions presented at the above-mentioned conference. The Law Research Network is thankful for the opportunity to publish them in *The Nordic Journal of European Law*, an open-access and peer reviewed journal of European law with a Nordic perspective. The Journal was launched by Lund University in cooperation with other Nordic universities. The articles in this special issue cover many different yet very interesting legal aspects as it is described in the following.

Firstly, Nuno Albuquerque Matos explores the issue of balancing an economic union through the market process. The article focuses on how to achieve balance between the Union and Member States through the market process, namely by creating a legal framework for sovereign debt restructuring. After a brief comparative institutional analysis, it highlights the importance of the market process, in particular of sovereign debt restructuring in general. The study then deals with the main challenges usually associated with a debt restructuring framework, such as regarding collective action, Member States' autonomy, moral hazard and financial issues. The author further reflects on the admissibility of such a procedure from a constitutional perspective, namely the EU Treaties and, lastly, on its democratic necessity.

Secondly, Danuta Kabat-Rudnicka deals with the operationalization of the rule of law. The study starts with some remarks on the rule of law, followed by an analysis of the judgment in the case *Associação Sindical dos Juízes Portugueses*, ways to protect the rule of law, its implications and concluding remarks. The research area is circumscribed to the EU and its Member States. The research question comes down to the issue of how the rule of law can be operationalised in a non-state, i.e. a supranational context. In turn, the article also deals with the role of institutions in the operationalisation of the rule of law, the ways to protect this very value and especially the role of the Court of Justice (hereinafter: CJEU/Court) in this process. It is highlighted that Article 2 TEU not only contains values the EU is based on, including the rule of law, but also underlines the importance of upholding them within the EU itself and its Member States. Operationalisation of the rule of law consists not only in translating this abstract concept into principles and rules but also into practical measures that can be used to assess compliance with the rule of law in a given legal system, either EU or national. Importantly, compliance with the said value is also indispensable for ensuring the EU's legitimacy, effectiveness, and protection of fundamental rights. Hence, the Member States must abide by EU law, even within areas of their reserved competence. Member States must therefore respect the rule of law which has been elevated to the rank of 'value', i.e. the leading axiological category underlying the Union – an element of the European constitutional identity.

Thirdly, Victoria Koutsoupia addresses some of the issues posed by modern technology in the sphere of money laundering and terrorist financing (ML/TF), in particular concerning confiscation of proceeds of crime. After briefly describing the development of digital currencies and their role in the growing importance of blockchain technology, the author explores the use of digital currencies for these criminal purposes. Interestingly, mixed views exist in this regard, as the potential for exploring this new technology for ML/TF is not horizontally accepted yet. The described framework is then used to focus on confiscation, where the author exposes some of the legal challenges, for instance the acceptance of digital currencies as 'currency' or 'money'. Moreover, features such as anonymity, difficulty of traceability and possibility of cross-border transactions further add to the burdensomeness to detect, investigate, prosecute and confiscate. This explains the relatively few court cases on the topic. However, when they occur, the author argues, the main challenge is related to the removal of criminal proceeds or assets when they are digital currencies stored with a private key known only to the owner. Thus, regulatory intervention is needed, according to the author, namely at EU level.

Fourthly, Hana Kováčiková addresses the issue of the rule of law in the EU from a non-court perspective. Acknowledging that the judicial process and the political sanctions envisaged in Article 7 of the TEU are not an effective tool, the author explores whether other ways are better to achieve compliance of the rule of law principle. The author starts from the observation that limiting or suspending financial streams proved to be an effective tool in the past. For instance, conditional grants became more visible during the 2014-2020 EU multi-annual financial framework. In the aftermath of the adoption of NGEU, however, a number of Regulations were adopted, such as the Conditionality Regulation (European Parliament and Council Regulation (EU, EURATOM) 2020/2092) the Common Provision Regulation (European Parliament and Council Regulation (EU) 2021/1060) and Recovery and Resilience Regulation (European Parliament and Council Regulation (EU) 2021/241). From a financial perspective, the author argues that, under the Conditionality Regulation, rule of law backsliding might entail suspension, reduction or interruption of payments or budgetary commitments. The obligation to fulfil financial commitments towards final beneficiaries remain preserved. However, in the case of Hungary, a decision took very long to be taken and proved not to be effective afterwards. Further, the Common Provision Regulation builds on the Conditionality Regulation, namely regarding respect for fundamental rights. Though firm conclusions are not possible to be drawn yet, the author presents a skeptical outlook and fears the Commission is not using every tool in the kit. In contrast, the Recovery and Resilience Facility show signs of positive outcomes. In fact, it is argued that the RRF's performance-based features, such as conditioning the disbursement of funds on compliance with qualitative and quantitative targets have shown promising results.

Finally, Andreas Corcaci addresses the topic of implementation of decisions on environmental conflicts beyond the nation state. He does this by theorizing the national implementation of European and international decisions on environmental conflicts, integrating both judgments from courts and so-called managerial decisions from (non-)compliance mechanisms in multilateral environmental agreements. In addition, the author argues that implementing legal obligations is crucial to protecting the environment, especially in the absence of specialized courts and political resistance from populist governments. To

do this, the author outlines a concept of structural methodology based on two hypotheses: one based on the mechanisms used to solve conflicts, and another relating to the legitimacy of relevant institutions and processes of conflict resolution. According to the author, the framework proposed enhances research on comparative implementation by enabling empirical comparisons across different types of court and non-compliance mechanisms. In addition, it assesses the role that legitimacy and informal cooperation mechanisms play in this realm.

The Law Research Network

BALANCING THE RELATIONSHIP BETWEEN THE UNION AND MEMBER STATES THROUGH THE MARKET PROCESS

NUNO ALBUQUERQUE MATOS*

There are mainly two paths to fiscal discipline within a federation or within a monetary union: either through markets or through hierarchy. By establishing the no-bailout clause, the Stability and Growth Pact and the Excessive Deficit Procedure, it was thought that the Maastricht Treaty had chosen market mechanisms to achieve that objective. However, the financial crisis showed the severe shortcomings of the model, marking a shift towards surveillance. This article argues that such failure was not due to the market mechanism but by flawed institutional choices. By establishing a procedure for fiscal adjustment, Member States cast doubt on the credibility of the no-bail out clause and took matters into the political realm. As a result, the political process was at the forefront since inception. There are several ways to deliver a certain social goal. Accordingly, goal choice and institutional choice are inextricably linked because it is the institutional choice which connects goals with their legal or public policy results. Importantly, to choose the best avenue comparative institutional analysis needs to be conducted. After briefly considering the political process, this article purports that other processes should be fully explored. When addressing the financial crisis in multi-level governance, some alternatives have already been employed: state default and supranational bailout. Within the EMU, no State has defaulted on its debt obligations prior to receiving a bailout. However, there is room to explore an option that would be based on market mechanisms with judicial elements while reducing dependence on the political process in the long-term: allowing Member States to orderly default on their debts. The article discusses its main problems, constitutional admissibility and democratic necessity.

1 INTRODUCTION

One very important question loomed while setting up the Economic and Monetary union (EMU) in the European Union (EU or Union): whether and how different Member States, with very diverse economic structures, would adjust, endure and thrive under a common currency.

To achieve a positive outcome, the Maastricht consensus was based on the principle of market pressure. In essence, it conveys the idea that Member States without monetary policy autonomy should rely solely on fiscal policy for public debt management.[1] Crucially, members of a monetary union issue government debt in a currency they do not control and, as a consequence, cannot always guarantee repayment to bondholders. On the contrary, countries not participating in a monetary union can provide a higher degree of trust because they have their own central banks. This contrast creates a situation where a liquidity crisis can occur within a monetary union and, because such a crisis leads to significant increases in the interest rate on public debt, it may result in default. Given this framework, countries

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[1] Fabian Amtenbrink, 'Economic and Monetary Union' in Pieter Jan Kuijper et al (eds), *The Law of the European Union* (5th edn, Wolters Kluwer 2019) 883, 906.

should be provided with an incentive to maintain their debt at manageable levels, since otherwise markets would signal this by raising interest rates on bonds.

Hence, market pressure was translated into a no-bail out clause and the adoption of several public finance instruments, such as the Stability and Growth Pact (SGP) and the Excessive Deficit Procedure (EDP). Observance of these instruments would be entrusted to the European Commission (Commission) and, ultimately, sanctions would be decided by the Council of the European Union (Council).

Nevertheless, the intensity of macroeconomic instability and asset overvaluation in years of economic prosperity as well as excessive austerity in years of economic recession has brought about scepticism regarding the role of the market.[2] While before the crisis markets did not flag risk potentially emanating from peripheral countries' sovereign debt, after the crisis they exaggerated risks dramatically, which is referred to as a failure of the market.[3]

While there is support for the understanding that market failure is a major cause of instability in European economic integration, the view purported here is that, on the contrary, it is a symptom of flawed institutional choices. At the outset, the existence of a procedure to require Member States to perform fiscal adjustments in the event of the excessive debts or deficits, in fact, casts doubt on the credibility of the no-bail out clause, as excessive debt accumulation is only a problem if there is a reason to expect that ensuing difficulties will be resolved through a bailout.[4]

Moreover, when the SGP was not enforced after its initial breach, neither by Member States[5] nor by the Court,[6] it sent a dual signal to both the market and the individual Member States. On the one hand, that fiscal discipline was not as highly valued a feature as previously assumed and, implicitly, a perception of bailout began to develop. On the other hand, the largest Member States had the political power to circumvent the rules, while smaller countries engaged in creative accounting without facing punishment. These actions inadvertently undermined market discipline. How could a bailout be ruled out if it was politically

[2] Paul de Grauwe and Yuemei Ji, 'Mispricing of Sovereign Risk and Macroeconomic Stability in the Eurozone' (2012) 50 Journal of Common Market Studies 866, 877.

[3] ibid. See also Olli Rehn, 'Economic Governance in a Changing Union: Fiscal Rules and Market Discipline in the Euro Area' in Koen Lenaerts et al (eds), *An Ever-Changing Union?Perspectives on the Future of EU Law in Honour of Allan Rosas* (2020) 83, 86-89, where the author indicates his view that markets have been trusted too much to deliver discipline on their own.

[4] Barry Eichengreen and Jürgen Von Hagen, 'Fiscal Restrictions and Monetary Union: Rationales, Repercussions, Reforms' (1996) 23 Empirica 3, 15.

[5] The first breach took place in 2003 by France and Germany. However, strict implementation of the SGP was blocked by some Member States, which led to the first revision of the Pact. On this see Antonio Estella, *Legal Foundations of EU Economic Governance* (Cambridge University Press 2018) 134. But this was not the first breach of the Pact, as it also occurred at least in 2014 and 2016. In this vein see Roger Kelemen, 'Commitment for Cowards: Why Judicialization of Austerity Is Bad Policy and Even Worse Politics' in Tom Ginsburg, Mark D Rosen, and Georg Vanberg (eds), *Constitutions in Times of Financial Crisis* (Cambridge University Press 2019) 157. Criticising the Court as a promoter of the ensuing fiscal indiscipline, see Gavin Barrett, 'The Role of Courts in the Eurozone' in Martin Belov (ed), *Judicial Dialogue* (Eleven International Publishing 2019) 127, 129. However, the author also states that budget discipline is often an area of high political salience and controversy, which can seldom be resolved with legal decisions.

[6] Case C-27/04 Commission of the European Communities v Council of the European Union EU:C:2004:436.

impossible to enforce the rules put in place to prevent it? Hence, institutional failure occurred.[7]

In turn, the development of this understanding of the market process led to institutional failure resulting in failure of institutional choice. Indeed, the evolution of the economic governance framework towards a surveillance paradigm, including the adoption of the six-pack, two-pack or the Treaty on Stability, Coordination and Governance has imposed extensively detailed constraints. Arguably, these constraints evolved into a dysfunctional process.[8]

Crucially, the fact that Member States have their overall budgets reviewed by the Commission and their fellow Member States in the Council exacerbates the problem. In fact, if Member States experience economic and financial hardship, they may be tempted to shift the blame to EU institutions. These institutions, in turn, will be seen as co-responsible for economic instability and potential collapse, thus increasing the likelihood of a bailout. In short, this reinforces the supranational political process as the prominent one in delivering fiscal and financial stability, indicating a certain level of co-responsibility.

Hence, this article will focus on how to achieve balance between the Union and the Member States though the market process, specifically by creating a legal framework for sovereign debt restructuring. Although this pillar would not act in isolation, it is nevertheless an essential component in the *iure condendo* process that could be designated as the horizontalisation of EU integration, considering the increased participation of different institutional actors and the detachment of the political process it would foster.

The present article is structured as follows: in section 2, a brief comparative institutional analysis will be performed and the importance of the market process, particularly regarding sovereign debt restructuring in general, will be highlighted. Section 3 will address the main challenges, usually associated with a debt restructuring framework, specifically concerning collective action, Member States' autonomy, moral hazard, and financial issues. Section 4 will reflect on the admissibility of such a procedure from a constitutional perspective, namely the EU Treaties and, lastly, section 5 on the democratic necessity.

2 BRIEF COMPARATIVE INSTITUTIONAL ANALYSIS AND IMPORTANCE OF SOVEREIGN DEBT RESTRUCTURING

The 2008 financial crisis marked a significant shift in the EU from a market-based into a surveillance paradigm. In essence, this shift implies that economic intermediation is no longer primarily based on market mechanisms but instead is concentrated in the political process.

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[7] Jonathan Rodden, 'Market Discipline and U.S. Federalism' in Peter Conti-Brown and David Skeel (eds), *When States Go Broke: The Origins, Context, and Solutions for the American States in Fiscal Crisis* (Cambridge University Press 2012) 130. The author points out that the Brazilian and Argentine federal systems also had elaborated procedures for monitoring and regulating the debts of states and provinces. Unfortunately, however, these regulations and procedures were undermined by the politics of federalism. In Brazil, for instance, the Senate was responsible for approving and regulating the borrowing of states, and representatives of insolvent states found that approval for unsustainable borrowing was relatively easy to obtain as part of the game of legislative horse trading. Similar to the Eurozone, if officials found it politically impossible to sanction São Paulo for its dubious loans from state-owned banks, how could they possibly gather political support to allow it to default?

[8] Christian Joerges, 'Pereat Iustitia, Fiat Mundus: What Is Left of the European Economic Constitution after the Gauweiller Litigation?' (2016) 23 Maastricht Journal of European and Comparative Law 99, 113.

In economic policy matters, this shift has brought about changes in the relationship dynamic between supranational and national authorities. The dependency from the former has grown steadily since the surveillance framework was set up as a response to the financial crisis. This dependence is evident in several ways: direct provision of financial assistance to Member States, indirect support for maintaining affordable interest rates in the bond market and the growing reliance of EU regional policy in public investment in various countries. These developments have been accompanied by legal changes that impose stricter restrictions and monitoring of public finances. However, there has been only modest progress in reducing debt as some Member States have exceeded the maximum allowed debt-to-GDP threshold by more than double.

At the same time, the judiciary has a limited role in enforcing public finance restrictions.[9] In fact, the opposite often holds true, as courts rarely have the required expertise or the necessary tools to comprehensively evaluate all the implications that decisions regarding debt and deficits involve: both the market and the political processes are better equipped to handle this task, given their access to experts who support the decision-making process.

Furthermore, budgetary decisions hold an inherent political nature. They often reflect the views of a majority at a particular point in time. Therefore, it is exceedingly challenging for the judiciary to incorporate this diversity to legal proceedings, at least not without significantly increasing the costs of the procedure, either by requiring more witnesses, hiring of experts to provide advice or by extending the time needed to reach a decision. These factors may explain why courts tend to defer to political institutions.[10] They do so because they may struggle to produce high-quality results, especially in complex situations such as evaluating public budgets and economic contexts.

When addressing the financial crisis in the context of multi-level governance, some alternatives have been employed: state default and supranational bailout. However, within the EMU, no State has defaulted on its debt obligations prior to receiving a bail-out.

Nevertheless, these are not the only alternatives to consider. There is room to explore another option, which would blend market and judicial elements while reducing dependence on the political process in the long-term: allowing Member States to orderly default on their debts. Such an option would yield three essential outcomes. Firstly, since a significant portion of the current EU economic governance framework would become obsolete, States would regain autonomy in defining their own economic and fiscal policies, thereby restoring democratic legitimacy. Secondly, fiscal responsibility would be integrated into the market process, increasing participation from actors beyond Member State governments and reducing inter-State politicisation of internal issues. Thirdly, as a result of these two mentioned outcomes, the fiscal choices and consequences of States would become an internal matter and largely cease to be a topic of an EU-wide discussion. Importantly, the

[9] In this vein see David Skeel, 'Institutional Choice in an Economic Crisis' (2013) 2 Wisconsin Law Review 629, 638. More generally see Neil Komesar, *Imperfect Alternatives: Choosing Institutions in Law, Economics and Public Policy* (The University of Chicago Press 1997) 53, arguing courts' capacity is limited and that the costs of participation in the judicial process are high.

[10] Carlos Aymerich, 'Challenging Austerity before European Courts' in Anuscheh Farahat and Xabier Arzoz (eds), Contesting Austerity: A Socio-Legal Inquiry (Hart Publishing 2021) 99; Cesare Pinelli, 'Are Courts Engaged in a "Dialogue" on Financial Matters?' in Martin Belov (ed), *Judicial Dialogue* (Eleven International Publishing 2019) 111.

establishment of a proper legal framework for fiscal responsibility would help rebuild inter-State trust.

Bankruptcy procedures are typically designed for companies, although they have also been applied to local and municipal governments.[11] Currently, there are no bankruptcy procedure in place for sovereign entities, whether unitary or federal states (including at sub-national level). Sovereign debtors are both uniquely vulnerable to, and uniquely shielded against, creditors' legal remedies. Unlike corporate bankruptcy procedures, there are no laws that would protect an overindebted sovereign borrower from legal actions by creditors in the event of non-compliance with payment obligations. Simultaneously, there is no orderly, court-supervised procedure in place to reorganize a sovereign entity's financial affairs. As a result, when it comes to debt instruments, especially those governed by foreign law, there are two alternatives:[12] either pay the debt according to its contractual terms or face enforcement action.

Nonetheless, the strength of creditors is also their weakness. Sovereigns can be held accountable when engaging in commercial activities outside their borders, either by adhering to the restrictive theory of sovereign immunity or by including a waiver of sovereign immunity in bond contracts. This waiver secures the sovereign's consent to foreign jurisdiction and judgment enforcement proceedings. However, sovereigns often have limited assets abroad,[13] with a significant portion held by central banks, which are typically considered as separate legal entities and are usually inaccessible for satisfying creditor's claims.[14] From an international law perspective, general bankruptcy principles and outcomes, such as the 'no creditor worse off principle', cannot be applied because states are not subject to liquidation.[15] Additionally, sovereigns enjoy protection from governance constraints that could be imposed during a bankruptcy procedure, as there can be no insolvency court or

[11] For instance, in the US, the first federal municipal bankruptcy statute was passed in 1933, whereby municipalities were permitted to negotiate settlements of their debts with their creditors. Once a settlement was approved by a certain percentage of the creditors (seventy-five percent) it could be imposed on the minority. As for the courts, they did not have jurisdiction or control over the municipalities governing powers. However, they were required to determine the plan's fairness and equitability. Currently, it is regulated under chapter 9 of the US bankruptcy law. No such legal framework exists at EU-level.
In Portugal, the law on the finances of local municipality and inter-municipality (Law No 73/2013) establishes a mechanism for municipal financial prevention and recovery, every time the legally establish debt level is overcome. Financial recovery procedures may be mandatory or voluntary, depending of the level of financial imbalance. As a general rule, the State cannot assume responsibility for the obligations of municipalities, nor can it assume the commitments arising from them. Although the procedure does not allow for debt restructuring, it does hinder access to budgetary funds which would otherwise be spent by municipalities. In any case, there is certainty that financing will occur from the national government and, as such, shields them from market forces' deterrent effect.

[12] In the case of domestic-law governed bonds, there is a possibility of imposing a particular solution, for instance by legislative fiat. This was the case in Greece which, in 2012, in the midst of its debt restructuring, passed a law imposing collective action clauses in all local law bonds, with retroactive effects. See Jeromin Zettelmeyer, Christoph Trebesch, and G Mitu Gulati, 'Managing Holdouts: The Case of the 2012 Greek Exchange' in Rosa Maria Lastra and Lee Buchheit (eds), *Sovereign Debt Management* (Oxford University Press 2014) 25.

[13] Rosa Maria Lastra, 'How to Fill the International Law Lacunae in Sovereign Insolvency in European Union Law?' *ESCB Legal Conference 2016* (European Central Bank 2017) 56, 57.

[14] Lee Buchheit and Elena Daly, 'Minimizing Holdout Creditors: Carrots' in Rosa Maria Lastra and Lee Buchheit (eds), *Sovereign Debt Management* (Oxford University Press 2014) 3; See also Robert Kolb, 'Sovereign Debt: Theory, Defaults, and Sanctions' in Robert Kolb (ed), *Sovereign Debt: From Safety to Default* (Wiley 2011) 3.

[15] Steven Schwarcz, 'A Minimalist Approach to State "Bankruptcy"' (2011) 59 UCLA Law Review 324, 335.

other bodies determining policy choices. However, it is worth noting that this notion has somewhat evolved, especially during the eurozone crisis.[16]

Despite these advantages, this solution is often met with scepticism. In fact, critics typically highlight several challenges. In the following section, some of the most significant challenges in the context of the EMU's current institutional framework will be addressed.

3 MAIN CHALLENGES

3.1 ISSUES RELATED TO COLLECTIVE ACTION

While most sovereign entities adhere to their debt obligations, there are instances when they find themselves unable to service their bonds. In such cases they typically engage with their creditors to negotiate an agreement. Ideally, financial terms of the settlements will be favourable to the debtor, often in the form of debt relief. Conversely, this increases the likelihood of compliance, improving the creditor's prospects for repayment when the obligations are due.

However, what if one or a few creditors disagree with the terms agreed upon by the majority of creditors, and refuse to give their consent to bond exchange? This issue is generally referred as the 'holdout problem'. These creditors can create two sets of issues. First, in the absence of provisions (of contractual or legislative nature) stating otherwise, a deadlock situation can emerge, whereby any modification to the bond can only be successful if consent is granted by every bondholder. Veto power is, therefore, granted to all of them, thereby creating the conditions for minoritarian bias, that is, a minority (or only one, for that matter) may prevent a situation generally favourable and agreed to by the (large) majority.

Secondly, it may foster a 'rush to the exit', which means that some creditors may resort to enforcement action sooner rather than later, in an effort to recover the full value of their bonds instead of being faced with a settlement subsequently negotiated by the majority of creditors. And, by doing so, the other bondholders may find themselves with fewer options.[17]

In essence, there are two main avenues to devise State restructuring: the institutional and the contractual way.

3.1[a] Procedure-based State restructuring

The institutional approach involves establishing a well-defined legal procedure.[18] Notably, Adam Smith recognised the necessity for such a method. In his words, '[w]hen it becomes necessary for a State to declare itself bankrupt, in the same manner as when it becomes

[16] For an overview, see Menelaos Markakis, *Accountability in the Economic and Monetary Union: Foundations, Policy and Governance* (Oxford University Press 2020).

[17] David Billington, 'European Collective Action Clauses' in Rosa Maria Lastra and Lee Buchheit (eds), *Sovereign Debt Management* (Oxford University Press 2014) 399, 400.

[18] This procedure has been labelled as 'statutory' or 'restructuring mechanism', which entails a supranational administrative body (either the IMF or some other) to manage the process. However, as the term procedure-based is preferred here, in order to capture the idea of a structured, open and transparent process, regardless of the managerial body and its legal nature.

necessary for an individual to do so, a fair, open and avowed bankruptcy is always the measure which is both least dishonorable to the debtor, and least harmful for the creditor'.[19]

While a procedure-based approach has not yet been fully implemented, several proposals have emerged with many drawn inspirations from US bankruptcy laws, specifically chapter 9 (pertaining to municipalities) or chapter 11 (concerning corporations). These proposals often aim to achieve a few key objectives: allowing for a temporary halt on creditor claims, resolve holdout issues by bolstering creditor coordination and establishing a mechanism, which permits new funding during the restructuring process and after it.

The earliest attempt to create a formal mechanism goes back to 1979, when a group of developing countries proposed the formation of an international debt commission, which was responsible for addressing various emerging crises. Despite never coming to fruition, due to opposition from creditor countries and lack of authority to enforce binding decisions, some of its objectives remain relevant. These include debt reorganisation, party coordination, appointment of a neutral arbiter or mediator as well the facilitation of raising new financing.[20]

Following the debt crises of the 1980s, there was a growing interest in extending some type of bankruptcy protection to sovereign States. In this context, in 1981, Christopher Oechsli proposed a procedure analogous to chapter 11 of US bankruptcy code. Oechsli argued that many of the procedures outlined in chapter 11 could be applied to renegotiation of debt in less developed countries. These procedures included the establishment of a creditor committee, an independent examiner, a monitoring party, which does not take control of the debtor's business, and a formal initiation procedure. Oechsli emphasized that the IMF could be entrusted with monitoring but stressed the importance of including debtors in the formulation of a restructuring plan. Regarding the initiation procedure, it should be triggered by both creditors or debtors, although creditors and the IMF may not necessarily accept the debtor petition.[21]

Debevoise adds to Oechsli's proposal by suggesting that Article VIII (2) (b) of the IMF's Articles of Agreement grants the authority to order a stay on collection of debt.[22] This interpretation would indeed enable the IMF to issue a payment standstill decision with broad implications.

In 1995, Jeffrey Sachs made an influential contribution, which would shape many subsequent proposals, arguing the IMF transitioning from being primarily an international lender of last resort to more of a bankruptcy court. Sachs contended that due to the nature of the IMF lending 'taxpayer dollars', it was exceedingly cautious about providing funds in risky circumstances. However, he pointed out that extreme crises involve risks.

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[19] Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (The Electronic Classics Series 2005) 770.

[20] Kenneth Rogoff and Jeromin Zettelmeyer, 'Bankruptcy Procedures for Sovereigns: A History of Ideas, 1976-2001' (2002) IMF Staff Papers 49(3), 472 <https://www.imf.org/en/Publications/WP/Issues/2016/12/30/Bankruptcy-Procedures-for-Sovereigns-A-History-of-Ideas-1976-2001-15993> accessed 10 December 2023

[21] Christopher Oechsli, 'Procedural Guidelines for Renegotiating LDC Debt: An Analogy to Chapter 11 of the U.S. Bankruptcy Reform Act' (1981) 21 Virgina Journal of International Law 305.

[22] Whitney Debevoise, 'Exchange Controls and External Indebtedness: A Modest Proposal for a Deferral Mechanism Employing the Bretton Woods Concepts' (1984) 7 Houston Journal of International Law 157.

Consequently, IMF loans tended to be insufficient and often arrived late. By the time these loans were disbursed, the government might have already lost control of the situation.[23]

This led to the well-known Sovereign Debt Restructuring Mechanism (SDRM) proposal by Anne Krueger, who was acting as first deputy managing director of the IMF, in 2001.[24] The author presented this tool as a 'catalyst' to encourage debtors and creditors to negotiate unsustainable debt restructuring in a timely and efficient manner, as long as these negotiations were conducted in good faith and led to policies capable of preventing similar problems from arising in the future. In return, the debtor country would be granted legal protection from creditors opposing restructuring. In Krueger's view,

> [t]he mere knowledge that such a framework was in place should encourage debtors and creditors to reach agreement of their own accord. Our model is one of a domestic bankruptcy court, but for a number of reasons it could not operate exactly like that. It is better to think of it as an international workout mechanism.[25]

According to Rogoff and Zettelmeyer, this proposal is welcome on two fronts: motivation and good behaviour incentives.[26] Concerning motivation, the IMF's unilateral standstill procedure is a suitable mechanism to address liquidity crises, debt crises and emphasize bailout implications on moral hazard. Regarding behaviour incentives, it explicitly references debtor good faith as a critical issue, in line with the US Bankruptcy Code, Chapter 11 (Section 1123), which links it to the principle of necessity, meaning that the debtor shall not seek debt reduction beyond what is necessary to establish medium-term debt sustainability.

In 2016, Guzman and Stiglitz proposed a Soft Law Mechanism for Sovereign Debt Restructuring.[27] This mechanism was based on nine UN principles on Sovereign Debt Restructuring processes, which were approved by the UN General Assembly in September 2015.[28] The proposed mechanism recognised that the sovereign states must have the right to determine their policies, in alignment with their objectives, including the right to

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[23] Jeffrey Sachs, 'Do We Need an International Lender of Last Resort' (1995) *Frank D. Graham Lecture at Princeton University*, 14 <https://www.jeffsachs.org/newspaper-articles/rnscc4pw7ep45shcf835rm8652tfpt> accessed 10 December 2023.

[24] Anne Krueger, 'A New Approach to Sovereign Debt Restructuring - Address by Anne Krueger, First Deputy Managing Director, IMF' (26 November 2001) <https://www.imf.org/en/News/Articles/2015/09/28/04/53/sp112601> accessed 10 December 2023; Anne Krueger, 'A New Approach To Sovereign Debt Restructuring' (2002) <https://www.imf.org/external/pubs/ft/exrp/sdrm/eng/sdrm.pdf> accessed 10 December 2023. For a detailed analysis of SDRM, see Rodrigo Olivares-Caminal, 'Statutory Sovereign Debt Resolution Mechanisms' in Rosa Maria Lastra and Lee Buchheit (eds), *Sovereign Debt Management* (Oxford University Press 2014) 333.

[25] Krueger, 'A New Approach to Sovereign Debt Restructuring - Address by Anne Krueger' (n 24).

[26] Rogoff and Zettelmeyer (n 20) 490.

[27] Martin Guzman and Joseph Stiglitz, 'A Soft Law Mechanism for Sovereign Debt Restructuring: Based on UN Principles' (2016 Friedrich Ebert Stiftung) <https://library.fes.de/pdf-files/iez/12873.pdf> accessed 10 December 2023. Similar features have been proposed by Kathrin Berensmann and Angélique Herzberg, 'An Insolvency Procedure for Sovereign States: A Viable Instrument for Preventing and Resolving Debt Crises?' in Robert Kolb (ed), *Sovereign Debt: From Safety to Default* (Wiley 2011) 379. For an analysis, see Giuseppe Bianco, *Restructuring Sovereign Debt: Private Creditors and International Law* (University of Oslo: Faculty of Law 2018).

[28] United Nations, 'Resolution Adopted by the General Assembly on 10 September 2015' (2015) <https://digitallibrary.un.org/record/804641> accessed 10 December 2023. This was preceded by United Nations, 'Resolution Adopted by the General Assembly on 9 September 2014' (2014) <https://documents-dds-ny.un.org/doc/UNDOC/GEN/N14/530/05/PDF/N1453005.pdf?OpenElement> accessed 10 December 2023.

decide whether to restructure their debt (sovereignty principle). However, a duty to negotiate in good faith would apply to both debtor and creditors when the sovereign's debt position becomes unsustainable (good faith principle), with the goal of restoring sustainability (sustainability principle). This duty also includes the obligation to disclose potential conflicts of interest, which could undermine the outcome of a restructuring process, such as holding credit default swaps (transparency principle). Creditors should be treated impartially, independently (impartiality principle) and in a non-discriminatory manner (equitable treatment principle), while debtors should be protected under the principle of international law, which states that no country can renounce its immunity (sovereign immunity principle). Importantly, all aspects of the restructuring procedure, including its institutions and operations, should adhere to requirements of inclusiveness and the rule of law (legitimacy principle). Lastly, sovereign debt restructuring agreements, which are approved by a qualified majority of creditors should not be affected by a minority of creditors, who must respect the decisions adopted by the majority. To achieve this, the UN encourages states to include Collective Action Clauses (CAC) in their sovereign debt issuances (majority restructuring principle).

Plans for an EU mechanism have also been proposed. The creation of a European Sovereign Debt Mechanism, similar to Anne Kruger's proposal, has been suggested.[29] Other proposals, based on the ESM, have also been developed by the Committee on International Economics and Policy Reform[30] and the German Council of Economic Experts.[31] The former proposes amending the ESMT to (i) condition ESM lending on certain debt thresholds and (ii) prevent holdouts in ESM-sanctioned debt restructurings from enforcing their claims through European courts. At the same time, 'both the restructuring country and "innocent bystanders" would need to have access to ESM lending to deal with the fallout of a restructuring'.[32] The latter is based on maturity extensions to address liquidity crises and, if necessary, significant debt restructuring when solvency issues are involved. Significantly, it assigns the ESM the task of assessing and imposing the terms of a sovereign debt restructuring.

3.1[b] Collective actions clauses

A CAC is a contractual provision in the multi-creditor debt instrument, which allows the majority of bondholders to agree to the modification of the contract, including payment

[29] Bettina Nunner-Krautgasser, 'The Importance of Being Prepared: A Call for a European Sovereign Debt Restructuring Mechanism' in Christoph Paulus (ed), *A Debt Restructuring Mechanism for Sovereigns: Do we need a legal procedure?* (C.H. Beck 2014) 241; Daniella Strik, 'Investment Protection of Sovereign Debt and Its Implications on the Future of Investment Law in the EU' (2012) 29 Journal of International Arbitration 183.

[30] Lee Buchheit et al, 'Revisiting Sovereign Bankruptcy: Committee on International Economic Policy and Reform' (October 2013) <https://scholarship.law.duke.edu/cgi/viewcontent.cgi?article=5904&context=faculty_scholarship> accessed 10 December 2023.

[31] Jochen Andritzky et al, 'A Mechanism to Regulate Sovereign Debt Restructuring in the Euro Area' (2016) Working Paper 04/2016 <https://www.sachverstaendigenrat-wirtschaft.de/fileadmin/dateiablage/download/publikationen/arbeitspapier_04_2016.pdf> accessed 10 December 2023.

[32] Buchheit et al (n 30) 35.

terms, provided that a certain threshold is met.[33] The most significant consequence of this provision is that the decision becomes binding on the dissenting minority.[34] In this regard, CACs serve a dual purpose: firstly, they facilitate sovereign debt restructuring and, secondly, they require investors to share the costs of borrowers' financial distress to thus reducing the burden on taxpayers.

Collective actions clauses have been promoted since 1995 by academics and public officials.[35] However, due to resistance from both creditors and borrowers, it was not until 2003 that they began to be widely adopted.[36] The shift occurred with the US Treasury initiative to include CACs in bonds issued under New York Law and EU Member States to incorporate these clauses into international debt issuances.[37]

There has been an increasing pressure to strengthen the contractual framework to more effectively address the collective action problem, particularly in light of the experience with the Argentine (2005) and Greek (2012) debt restructurings.[38] Pursuant to Article 12 (3) ESMT, in January 2013 the Eurozone initiated the inclusion of standardised 'double-limb' aggregation CACs in all new Euro area government bonds with maturities exceeding one year irrespective of whether the bonds were governed by domestic or foreign law. These CACs require that a minimum level of support must be achieved both across all series of securities being restructured and within each series. In the case of the Eurozone, the former requires a 75% threshold, while the latter requires a 66.67% mark.[39]

Subsequently, in 2014 the International Capital Market Association (ICMA) proposed enhancing CACs,[40] by advocating the use of single-limb clauses. These types of clauses enable the restructuring of bonds through a single vote, encompassing all instruments or a

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[33] A 75% majority of votes required is the typical form of CACs. However, according to Bradley and Gulati, voting threshold to change the terms may vary from 18.75% to 85% of the outstanding bondholders, the former being applied in case an initial quorum requirement is not satisfied. See Michael Bradley and Mitu Gulati, 'Collective Action Clauses for the Eurozone' (2014) 18 Review of Finance 2045.

[34] Lee Buchheit and Elena Daly, 'Minimizing Holdout Creditors: Sticks' in Rosa Maria Lastra and Lee Buchheit (eds), *Sovereign Debt Management* (Oxford University Press 2014) 15, 21.

[35] In the context of the G-10 meeting, whereby a Working Group was formed to propose policies for an orderly sovereign liquidity crisis of such a magnitude that rescue packages would not become a source of moral hazard. A report was delivered in 2012. See Group of 10, 'Report of the G-10 Working Group on Contractual Clauses' (2012) <https://www.bis.org/publ/gten08.htm> accessed 10 December 2023.

[36] Sönke Häseler, 'Collective Action Clauses in Sovereign Bonds' in Robert Kolb (ed), *Sovereign Debt: From Safety to Default* (Wiley 2011) 235.

[37] Economic and Financial Committee, 'Implementation of the EU Commitment on Collective Action Clauses in Documentation of International Debt Issuance' ECFIN/CEFCPE (2004) REP/50483 Final <https://europa.eu/efc/sites/default/files/docs/pages/cacs_en.pdf> accessed 10 December 2023.

[38] Kay Chung and Michael G Papaioannou, 'Do Enhanced Collective Action Clauses Affect Sovereign Borrowing Costs?' (2020) IMF Working Paper WP/20/162, 9. <https://www.imf.org/en/Publications/WP/Issues/2020/08/07/Do-Enhanced-Collective-Action-Clauses-Affect-Sovereign-Borrowing-Costs-48960> accessed 10 December 2023. See also Christian Hofmann, 'A Legal Analysis of the Eurozone Crisis' in Christoph Paulus (ed), *A Debt Restructuring Mechanism for Sovereigns: Do we need a legal procedure?* (Verlag C.H. Beck 2014) 43, 63.

[39] See 'Euro Area Model CAC 2012, Common Terms of Reference'(2012) <https://europa.eu/efc/sites/default/files/docs/pages/cac_-_text_model_cac.pdf> accessed 10 December 2023. See also European Council, 'European Council Meeting (24/25 March 2011) – Conclusions, EUCO 10/1/11' (2011) < https://data.consilium.europa.eu/doc/document/ST-10-2011-REV-1/en/pdf > accessed 30 May 2022.

[40] International Capital Markets Association, 'Standard Aggregated Collective Action Clauses ("CACS") for the Terms and Conditions of Sovereign Notes' <https://www.icmagroup.org/assets/documents/Resources/ICMA_Model_Standard_CACs_August_2014.pdf> accessed 10 December 2023.

subset of instruments, thereby preventing a creditor or group of creditors from holding in a particular series.[41] These single limb clauses were also endorsed by the IMF in the same year[42] and have gained widespread adoption worldwide.[43]

This development was followed by the Eurozone in December 2018, whereby the Eurogroup announced support among finance ministers to amend the ESMT. This amendment would require the gradual introduction of single-limb CACs in all Euro area issuances as from 2022, later confirmed by the Heads of State and Governments of the Euro area.[44]

3.1[c] Are collective action clauses sufficient and suitable?

Procedure-based sovereign debt restructuring is often considered unnecessary and inappropriate. It is unnecessary because the contractual approach has evolved and has proven to be an effective way to address the issue. In the EU context, some academics argue these clauses could serve as proxy for a bankruptcy procedure,[45] especially considering that most debt contracts already include single or double-limb clauses.[46] They are also deemed unsuitable because CACs strike a fair balance between creditors and debtors, avoiding 'regulatory overkill'.[47]

Others argue that CACs are an insufficient legal figure to effectively address the issue given the numerous existing gaps.[48] There are three main issues with CACs: insufficient comprehensiveness of debt restructuring, inadequate levels of debt reduction and the

[41] Chung and Papaioannou (n 38) 10.

[42] International Monetary Fund, 'Strengthening the Contractual Framework to Address Collective Action Problems in Sovereign Debt Restructuring' (October 2014) <https://www.imf.org/external/np/pp/eng/2014/090214.pdf> accessed 10 December 2023.

[43] European Central Bank, 'The IMF's Role in Sovereign Debt Restructurings' (September 2021) Occasional Paper Series 262 <https://www.ecb.europa.eu/pub/pdf/scpops/ecb.op262~f0e9e1e77e.en.pdf> accessed 10 December 2023.

[44] Euro Summit, 'Euro Summit Meeting (14 December 2018) - Statement, EURO 503/18' (2018) <https://www.consilium.europa.eu/media/37563/20181214-euro-summit-statement.pdf> accessed 10 December 2023. See also EFC Sub-Committee on EU Sovereign Debt Markets, '2022 Collective Action Clause: Explanatory Note' (2022) <https://europa.eu/efc/system/files/2021-04/EA Model CAC - Draft Explanatory Note.pdf> accessed 10 December 2023.

[45] In this sense see Yves Mersch, 'Reflections on the Feasibility of a Sovereign Debt Restructuring Mechanism in the Euro Area', *ESCB Legal Conference 2016* (European Central Bank 2017) 6. See also Ludger Schuknecht, 'The German Perspective: The Structure of the European Stability Mechanism' in Christoph Paulus (ed), *A Debt Restructuring Mechanism for Sovereigns: Do we need a legal procedure?* (C.H. Beck 2014) 185.

[46] Chung and Papaioannou (n 38) 10, signal that, as of March 2020, an estimated 1.3 trillion dollars of foreign law-governed bonds was outstanding. Approximately 51 % of the outstanding debt stock includes the single-limb CACs, while 45% has double-limb CACs. Only 4% did not include any CACs.

[47] Udaibir S Das, Michael G Papaioannou, and Christoph Trebesch, 'Sovereign Debt Restructurings 1950–2010: Literature Survey, Data, and Stylized Facts' (2012) IMF Working Paper 12/203 <https://www.imf.org/external/pubs/ft/wp/2012/wp12203.pdf> accessed 10 December 2023. See also Nouriel Roubini and Brad Setser, 'The Reform of the Sovereign Debt Restructuring Process: Problems, Proposed Solutions, and the Argentine Episode' (2004) 1 Journal of Restructuring Finance 173.

[48] Rosa Maria Lastra, 'How to Fill the International Law Lacunae' (n 13) 56 The author indicates issues regarding applicable law, litigation, collateral, human rights and protection of democracy. See also Christoph Paulus, 'How Could the General Principles of National Insolvency Law Contribute to the Development of a State Insolvency Regime?', *ESCB Legal Conference 2016* (European Central Bank 2017) 64, and Otto Heinz, 'Issues and Possible Reforms in the Context of a Euro Area/EU Sovereign Insonvency Framework', *ESCB Legal Conference 2016* (European Central Bank 2017) 93, 102.

challenge of securing new financing.[49] The first limitation is connected to the complexity of the debt profile. According to Bolton and Skeel, restructuring with CACs has predominantly been employed by smaller countries, displaying fewer complex profiles (for instance with fewer different bonds). Therefore, the diversity in bond legal terms, namely maturities and payout conditions, diminishes the effectiveness of the restructuring process. Furthermore, the extent of creditor losses is also strongly correlated with the holdout rate, as observed in cases, such as Ukraine in 1999 and Greece in 2012, which suggests that CACs alone do not assure full participation.[50]

Nevertheless, single-limb clauses represent an improvement. In fact, this form of CAC is the only one that minimizes the holdout problem. Empirical evidence demonstrates that single limb clauses help reduce holdout rates, especially when they entail substantial losses for creditors. On the contrary, CACs with bond-by-bond voting or two-limb structures are insufficient to achieve high participation rates.[51]

In this context, the Greek debt restructuring stands out, not only because it was the largest debt restructuring in the history of sovereign defaults, but also because it is the only Eurozone country to have undergone such a process to date. This restructuring was carried out through private sector involvement. Greece achieved a total participation of €199.2 billion, or 96.9% of eligible principal. As a result of this exchange, Greece's debt was reduced by approximately €107 billion, constituting 52% of the eligible debt. This implies that the creditors have accepted significant losses. The success of this operation was significantly aided by the introduction of single-limb CACs, which retroactively applied to all domestic bonds issued under Greek law.[52]

A closely related limitation is insufficient debt reduction. Private creditor in particular will carefully weigh the benefits and costs of reduced debt repayment. Therefore, a debt restructuring that is overly favourable to creditors may result in less significant improvement in the debt profile. In addition, it is important to note that CACs do not address a country's non-bond debt, such as bank loans.

Participation of public creditors is constrained for additional reasons. Article 125(1) TFEU, as interpreted by the CJEU in its case-law, allows for the provision of assistance under certain conditions. The question arises as to whether assistance can be construed in terms of granting access to credit or reducing the principal amount of debt. Ioannidis argues that the latter option could be acceptable if the perspective of protecting the interests of the public creditor is adopted.[53] Indeed, if there is a risk that, without restructuring, the public creditor would face even greater losses due to the debtor's inability to repay, then the purpose of their involvement would be to safeguard the creditor's investment, rather than providing the debtor with an alternative source of funding. According to the author, only the latter

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[49] Patrick Bolton and David Skeel, 'Inside the Black Box: How Should a Sovereign Bankruptcy Framework Be Structured?' (2004) 53 Emory Law Journal 763, 772.

[50] Chuck Fang, Julian Schumacher, and Christoph Trebesch, 'Restructuring Sovereign Bonds: Holdouts, Haircuts and the Effectiveness of CACs' (2021) 69 IMF Economic Review 155.

[51] ibid.

[52] Hofmann (n 38) 66; Lee Buchheit, 'Use of the Local Law Advantage in the Restructuring of European Sovereign Bonds' in Franklin Allen, Elena Carletti, and Mitu Gulati (eds), *Institutions and the Crisis* (European University Institute 2018) 95.

[53] Michael Ioannidis, 'Debt Restructuring in the Light of *Pringle* and *Gauweiller* - Flexibility and Conditionality', *ESCB Legal Conference 2016* (European Central Bank 2017) 81.

situation was intended to be covered and, thus, prohibited by the drafters of Article 125 TFEU.

This reasoning would also be in line with State aid law. When dealing with debtor enterprises, the CJEU has established a long-standing case law in assessing the requirement of economic advantage, as stipulated in Article 107(1) TFEU: the State should act as if it were a private creditor,[54] guided by profit maximisation and loss limitation, depending on the context.

Be that as it may, it is difficult to determine whether the motivation for restructuring is based on such considerations or is aimed at offering further assistance, as Ioannidis also notes.[55] In addition, it would make sovereign restructuring more contentious and, consequently, lengthier and adding more uncertainty as to the outcome.

In the current state of affairs, it seems more plausible that the teleology of Article 125 TFEU is more in line with the view that directly assuming the liabilities of a Member State or offering loans to provide payment for old liabilities and, subsequently, waiving these loans (as is the case with a restructuring of debt held by the public sector), should be seen as interchangeable measures[56] and, therefore, not be permitted. In the same vein, the ESMT in recital 12 only refers to private sector involvement, and even this option only applies in exceptional circumstances.

The ECB is also a relevant creditor in potential debt restructurings, given its ability to purchase significant quantities of sovereign bonds on secondary bond markets. In *Gauweiler*, the Court did not directly address the issue. Notwithstanding, it did state the ECB's lack of privileged creditor status meant that it would be exposed to the risk of a debt cut decided by other creditors. Significantly, it also stated that this risk should be understood as inherent to the purchase of bonds on the secondary markets, an operation authorised by the treaties without being conditional upon the ECB holding privileged creditor status.[57] However, it would be difficult to reconcile the statement in this paragraph with the objective of Article 123 TFEU which, paradoxically, the Court made reference to in this case, by emphasizing the need to avoid moral hazard and foster fiscal discipline. Given the foregoing, although the issue is not settled in the case-law, it is likely that a restructuring involving the ECB would breach the treaties and, therefore, prevented its participation.[58]

These limitations inherent to EU law are crucial, especially because the ESM is intended to be an institution, which provides loans (or other types of assistance) to ensure liquidity, ensuring Member States' ability to roll-over their debt obligation. In practice, there

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[54] Case C-342/96 *Kingdom of Spain v Commission of the European Communities* EU:C:1999:210; Samuel Cornella, 'The "Market Economy Investor Principle" to Evaluate State Aid: Latest Developments and New Perspectives' (2015) 22 Maastricht Journal of European and Comparative Law 553.

[55] Ioannidis (n 53) 81.

[56] Christian Hofmann, 'Greek Debt Relief' (2017) 37 Oxford Journal of Legal Studies 1, 24.

[57] Case C-62/14 *Peter Gauweiler and Others v Deutscher Bundestag* EU:C:2015:400 para 126. However, Advocate-General Cruz Villalón states, in his opinion, that the ECB would not actively contribute to bringing about a restructuring but would, instead, seek to recover in full the claim securitised on the bond – Opinion of AG Cruz Villalón in Case C-62/14 *Peter Gauweiler and Others v Deutscher Bundestag* EU:C:2015:7 para 235.

[58] Funds held by central banks usually enjoy immunity from satisfaction of creditors' claims in the context of their country's default, which was the case of Banco Central de la República Argentina, as described by Thomas Baxter and David Gross, 'Special Immunities: Central Bank Immunity' in Rosa Maria Lastra and Lee Buchheit (eds), *Sovereign Debt Management* (Oxford University Press 2014) 117. However, such cases are different from central banks directly participating in principal payment reduction of purchased bonds.

is a gradual shift in debt ownership, from the private sector to the public sector. Problematically, if the assistance programmes provide a significant amount of funding, it means that the ESM will progressively become a more important creditor. This could make meeting the CACs modification thresholds more challenging.

Importantly, the problem with ESM influence is that not only are funds controlled by Heads of State or Governments, potentially creating tensions between sovereigns,[59] but power is also skewed towards a few countries.[60]

Lastly, the issue of new financing arises. An essential feature of restructuring law in the US's Chapter 11 but also in the EU's Directive 2019/1023[61] is the possibility of obtaining debtor-in-possession (DIP) financing, in order to preserve company's value. DIP financing may be even more critical for sovereign debtors due to their vulnerability to capital flight as has already been alluded to. Arguably, the ESM could serve a similar function but, similarly to the IMF, it does not link its lending to a negotiation of a restructuring agreement between Member States and their creditors. Consequently, investors have an incentive to wait until a bailout becomes unavoidable and new financing is provided by public sector institutions.[62]

3.2 RESTRICTION OF MEMBER STATE AUTONOMY

One of the reasons why the IMF procedure was rejected was the fear of many countries losing national autonomy[63] and this fear is understandable, given the diversity within an institution composed of 190 members.[64]

This question is important because, unlike municipalities, states (both in the EU and in the US) are considered sovereign entities and, thus, any restriction on their autonomy should be anchored in the treaties or the respective Constitutions. This issue has received particular attention in the case law of the US Supreme Court. For instance, in 1936 *Ashton* case,[65] Justice Cardozo argued:

> There is room at least for argument that within the meaning of the Constitution the bankruptcy concept does not embrace the states themselves. In the public law of the United States a state is a sovereign or at least a quasi sovereign. Not so a local governmental unit, though the state may have invested it with governmental power. Such a governmental unit may be brought into court against its will without violating the Eleventh Amendment. It may be subjected to mandamus or to equitable remedies. Neither public corporations nor political subdivisions are

[59] In this vein see Paulus (n 48) 76.
[60] See Federico Fabbrini, *Economic Governance in Europe: Comparative Paradoxes and Constitutional Challenges* (Oxford University Press 2016).
[61] Directive (EU) 2019/1023 of the European Parliament and of the Council of 20 June 2019 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, and amending Directive (EU) 2017/1132 (Directive on restructuring and insolvency) [2019] OJ L172/18.
[62] Bolton and Skeel (n 49) 775.
[63] Christoph Ohler, 'Der Staatsbankrott' (2005) 60 JuristenZeitung 590, 598.
[64] See International Monetary Fund, 'List of Members' (last updated: August 30, 2023) <https://www.imf.org/external/np/sec/memdir/memdate.htm> accessed 10 December 2023.
[65] Ashton v Cameron County Water Improvement District No 1 [1936] 298 US 513, 542.

> clothed with that immunity from suit which belongs to the state alone by virtue of its sovereignty.

The application of the municipal bankruptcy act to the national level could, therefore, be unconstitutional if one embraces Justice Cardozo's view. However, from a financial perspective, a high burden of debt effectively limits autonomy,[66] since the fiscal position is used to assess credit risk. The higher the risk, the higher the cost of borrowing, resulting in a decrease in autonomy when defining national economic and fiscal policies.

A similar perspective was adopted by the US Supreme Court in the *Bekins* case,[67] when assessing the 1937 revised municipal bankruptcy law enacted by Congress. Given its voluntary nature and the passive role of the bankruptcy court, limited to approving or disapproving a presented plan, the US Supreme Court determined that the Federal Bankruptcy law should be understood as granting cities and States the power to impair contracts in case of dire financial situation, a prerogative that was previously reserved for the federal government. In this way, '[t]he bankruptcy power is competent to give relief to debtors in such a plight'. By removing such reserved power '[t]he State acts in aid, and not in derogation, of its sovereign powers' as '[i]t invites the intervention of the bankruptcy power to save its agency which the State itself is powerless to rescue'. In conclusion, the US Supreme Court argues that it sees 'no ground for the conclusion that the Federal Constitution, in the interest of state sovereignty, has reduced both sovereigns to helplessness in such a case',[68] especially considering that the statute was designed to respect the sovereignty of the State, for instance retaining control of its fiscal affairs.

However, the situation might not be as simple as the US Supreme Court presented and evaluated it regarding fiscal sovereignty of States. In McConnel's view, courts must determine eligibility to the bankruptcy process, which involves a judicial assessment of the applicant's solvency. This analytical exercise indirectly compels courts to evaluate whether a State has exhausted its capacity to generate revenue and reduce spending. Moreover, while courts lack the authority to create bankruptcy plans, they can refuse to accept a plan or condition their approval on the fulfilment of specific requirements. Both actions can significantly impact the sovereignty of Member States, as taxation lies at the core of their sovereign powers. In this sense, McConnel concludes that bankruptcy would, in practice, transfer control of fiscal affairs to the court.[69] This would be the case regardless of the body chosen to administer the process.

In the EU context, the situation is different. Member States have been committed to building an ever-closer Union since 1957. In the initial decades, integration predominantly deepened on the regulatory and technical fronts. Crucially, as this process continued, all countries became increasingly interdependent, leading to a growing necessity to accommodate the spillover effects of national measures. Consequently, this gradual interdependence has resulted in a reduction of Member States' autonomy.

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[66] In this vein see, in the doctrine, Nunner-Krautgasser (n 29) 243.
[67] United States v Bekins [1938] 304 US 27.
[68] ibid, 54.
[69] Michael McConnell, 'Extending Bankruptcy Law to States' in Peter Conti-Brown and David Skeel (eds), *When States Go Broke: The Origins, Context, and Solutions for the American States in Fiscal Crisis* (Cambridge University Press 2012) 229, 233.

More recently, the establishment of EMU has necessitated greater coordination on politically-sensitive topics, including national economic policies. As mentioned earlier, the European economic governance framework, implemented in response to the financial crisis, represents a fundamental shift in the relationship between the Union and its Member States. Under this framework Member States have ceded a significant portion of their sovereignty when it comes to freely designing their national economic policies. Instead, they must adhere to a strict procedure conducted by the Commission, which ultimately results in the approval or disapproval of national budgets at the supranational level.

Considering this context, a bankruptcy procedure would be less intrusive in comparison with other regions of the world,[70] particularly when viewed alongside the proposals presented elsewhere.[71]

3.3 MORAL HAZARD

In the debate on a sovereign bankruptcy framework, moral hazard is typically one of the main concerns.[72] In the EU, for instance, the concept of moral hazard has been at the forefront since the Treaty of Maastricht. This concern finds expression in Article 125(1) TFEU, which prohibits both the EU and Member States from assuming the financial commitments of another Member State. Article 123(1) TFEU also prohibited the ECB from engaging in monetary financing.

The prospect of a future debt relief may indeed exacerbate the problem of debt discontinuity,[73] which highlights the risks associated with the disconnect between the moment of issuance, the moment of payment, and corresponding accountability.

Moral hazard risk can be identified in several instances. First, it could empower States with a potent tool they could use to exert pressure on bondholders to accept the proposed new payment terms, in order to avoid a legal proceeding, or to seek a bailout from a supranational government.

Second, when a country faces financial distress, self-fulfilling runs on the country's debt may occur, creating multiple equilibria. As Panizza points out,

> in a good equilibrium, a solvent borrower has continuous access to finance and remains solvent. In the bad equilibrium, the sudden withdrawal of financial resources caused by panicked lenders can push an otherwise solvent borrower towards insolvency.[74]

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[70] David Skeel, 'Rules-Based Restructuring and the Eurozone Crisis' in Franklin Allen, Elena Carletti, and Giancarlo Corsetti (eds), *Life in the Eurozone With or Without Sovereign Default?* (FIC Press 2011) 97, 101. See also Jeannette Abel, *The Resolution of Sovereign Debt Crises: Instruments, Inefficiencies and Options for the Way Forward* (Nomos/Routledge 2017) 403.

[71] Nuno Albuquerque Matos, Next Generation EU and the Balancing of Economic Union Through Horizontalisation (2023) REBUILD Centre Working Paper No. 8/2023 <https://ssrn.com/abstract=4367092> accessed 10 December 2023.

[72] Ugo Panizza, 'Do We Need a Mechanism for Solving Sovereign Debt Crises? A Rule-Based Discussion' in Christoph Paulus (ed), *A Debt Restructuring Mechanism for Sovereigns: Do we need a legal procedure?* (C.H. Beck 2014) 223, 227.

[73] Stewart Sterk, 'The Continuity of Legislatures: Of Contracts and the Contracts Clause' (1988) 88 Columbia Law Review 647.

[74] Panizza (n 72).

In the latter situation, during bankruptcy proceedings, countries typically turn to the IMF as an effective international lender of last resort to provide bridge financing. In the EU, the IMF provided funding to certain countries during the sovereign debt crisis, alongside the EFSF and the ESM.[75]

However, while resorting to these lenders may contribute to managing financial instability, it may also be a source of moral hazard and overborrowing. In fact, as previously explained, if creditors know, or believe they can rely on a supranational institution to provide funding when sovereign defaults occur, they may become more careless in their lending practices than they would otherwise be. As Dooley argues, 'private creditors watch what the [International Monetary] Fund does very carefully, not for wisdom about the credit worthiness of countries, but for clues about the terms on which official creditors will lend to debtor governments'. Consequently, 'the "threat of crisis" is the only effective incentive for repayment by sovereign debtors'.[76]

Lastly, at the end of the bankruptcy procedure, moral hazard manifests itself in the form of debt pressure relief. As there is a means to discharge debt, incentives for complying with EU and national public finance obligations could diminish. In a way, bankruptcy could have the same effect as supranational bailouts.

Although these concerns are legitimate, this perspective undervalues the fact that reality is dynamic, not static. Relying on a bankruptcy procedure would prompt investor adjustment in the future by imposing a range of sanctions,[77] which could serve as a deterrent effect.

Moreover, it is premised on the assumption that decision-makers would be tempted by the bankruptcy option rather than viewing it as a last resort measure. Apart from the fact that States' governments can threaten to default on their debt even in the absence of a framework, Skeel convincingly argues that 'one of the most attractive features of state bankruptcy is the extent to which its benefits would arise even if no state ever filed for bankruptcy',[78] not least because of the presence of a neutral party ensuring the

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[75] For a thorough analysis of the institutional participation in the EU sovereign debt crisis see Nicolas Véron, 'The IMF's Role in the Euro-Area Crisis: Financial Sector Aspects' (2016) Bruegel Policy Contribution 13/2016 <https://www.bruegel.org/2016/08/the-imfs-role-in-the-euro-area-crisis-financial-sector-aspects/> accessed 10 December 2023.

[76] Michael Dooley, 'Can Output Losses Following International Financial Crises Be Avoided?' (2000) National Bureau of Economic Research Working Paper 7531 <https://www.nber.org/system/files/working_papers/w7531/w7531.pdf> accessed 10 December 2023.

[77] For instance economic sanctions, by increasing the cost of loans or hinder market access both to the public and private sectors, as well as decline in national output, as argued by Kolb (n 14) 7, and Odette Lienau, 'The Longer-Term Consequences of Sovereign Debt Restructuring' in Rosa Maria Lastra and Lee Buchheit (eds), *Sovereign Debt Management* (Oxford University Press 2014) 85. But also political sanctions, as shown by Carmen Reinhart and Kenneth Rogoff, *This Time Is Different: Eight Centuries of Financial Folly* (Princeton University Press 2010) and Daniel Waldenström, 'How Important Are the Political Costs of Domestic Defaults?' in Robert Kolb (ed), *Sovereign Debt: From Safety to Default* (Wiley 2011) 287. In the EU, the share of domestic debt (debt held by resident in a given Member State) is not negligible, granting voters relevant accountability power. In this vein see Daniel Gros, 'Restructuring in a Monetary Union: Economic Aspects' in Rosa Maria Lastra and Lee Buchheit (eds), *Sovereign Debt Management* (Oxford University Press 2014) 195.

[78] David Skeel, 'State Bankruptcy from the Ground Up' in Peter Conti-Brown and David Skeel (eds), *When States Go Broke: The Origins, Context, and Solutions for the American States in Fiscal Crisis* (Cambridge University Press 2012) 191, 195. With an opposing view, Edmund McMahon, 'State Bankruptcy Is a Bad Idea' (*Wall Street Journal*, 24 January 2011) <https://www.wsj.com/articles/SB10001424052748704881304576094091992370356> accessed 10 December 2023.

existence of due process.[79]

3.4 FINANCIAL PROBLEMS

3.4[a] Reputation and market access

One of the most important factors influencing debt payment is a country's reputation. As states aim to ensure access to future market financing, they prioritise debt repayments which, in turn, instils confidence in lenders to continue extending funding. This consequence was already recognised as the primary cost of default in US States in the 1840s,[80] even though it may not always be a primary concern.[81]

The fear for reputational sanctions also plays a significant role, potentially affecting relationships that rely on trust to some extent. For example, following a debt default, other governmental suppliers may begin to request advance payments before delivering goods or providing services. Similarly, the resident population may reduce their level of trust in government.[82] All these spillover events contribute to increase the overall cost of default.

This reasoning can be traced back to game theory, notably in repeated games. As Benoit and Krishna explain,

> [i]n a repeated setting, players can condition their behavior at any stage of the game on the observed past behavior of other players. As a result, a player may behave in a way that is not in his or her short run interests because any attempt to realize short run gains may lead to future losses if other players retaliate.[83]

Therefore, while it may seem advantageous for sovereigns to avoid complying with payment obligations in the short-term, the need for continued engagement with financial markets provides the necessary incentive to behave differently.[84]

In this context, it is argued that reputation costs can be effectively addressed by establishing a sovereign restructuring procedure. The idea is that institutionalisation would reduce costs by making it more socially acceptable and transparent: a country that undergoes such a procedure would be better positioned to gain trustworthiness, while a country that

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[79] Abel (n 70) 413; Patrick Bolton, 'Toward a Statutory Approach to Sovereign Debt Restructuring: Lessons from Corporate Bankruptcy Practice around the World' (2003) 50 IMF Staff Papers 41, 62.

[80] William English, 'Understanding the Costs of Sovereign Default: American State Debts in the 1840's' (1996) 86 The American Economic Review 259, 268. Market access disturbance also took place in Finland, during the years of depression in the 1990s. Finish bond yields rose quickly and widened very much compared to German equivalents. As Rehn explains, this mechanism, or its mere threat, could enforce the long-run budget constraint on an economy and prevent it from over-borrowing. See Rehn (n 3) 84.

[81] Smaller countries meet their debt-related obligations not so much to keep their reputation, because frequently it is not possible for them to display one, as argued by Jeremy Bullow and Kenneth Rogoff, 'Sovereign Debt: Is to Forgive to Forget?' (1989) 79 The American Economic Review 43. However, the authors mostly focus on Third-World debt management problems. In contrast, EU Member States are considered as being relatively rich countries and do have a reputation to cherish.

[82] Kolb (n 14) 8. The author exemplifies with defaults of the Spanish Empire in the XVIth century (inability to pay to the army); Peru in 1826 (fearing Europe, as main financiers and export destination, would seize exports as compensation); or Russia in 1993 (court litigation and seizures).

[83] Jean-Pierre Benoit and Vijay Krishna, 'Finitely Repeated Games' (1985) 53 Econometrica 905.

[84] In this vein, see Jonathan Eaton, Mark Gersovitz, and Joseph Stiglitz, 'The Pure Theory of Country Risk' (1986) National Bureau of Economic Research Working Paper No 1894 <https://www.nber.org/system/files/working_papers/w1894/w1894.pdf> accessed 10 December 2023.

relies on financial assistance will be perceived as a risk factor, potentially hindering new investment.[85] Moreover, the assumption that all creditors will cease lending if there is a default against one of them is empirically incorrect, as is the assumption that such exclusion will be permanent.[86]

3.4[b] Bond market disruption and contagion

Another objection raised is that a bankruptcy procedure could disrupt bond markets and increase states' borrowing costs, even those with stronger fiscal indicators due to contagion.[87]

In the EU, the argument was invoked by the ECB during the sovereign debt crisis.[88] In the US, similar arguments emerged in 1934, during the discussion preceding the enactment of Chapter 9 of the Bankruptcy Act by the US Congress, and in 2011 during the debate on exploring the possibility of States' bankruptcy bill, which was not adopted. Regarding the debate on Chapter 9, opponents of the bill contended that opening the doors of the bankruptcy court to municipal corporations represented a radical departure from long-established practices that would adversely affect municipal bond markets. They were particularly concerned about solvent cities being impacted by spillover effects from insolvent ones. Furthermore, opponents also argued that only a small percentage of municipalities would likely use such an instrument and, therefore, costs would outweigh benefits.[89]

Regarding the US States' potential bankruptcy bill, the main issue under discussion was the fear expressed by congressman Mike Quigley that bankruptcy filing by a few States would trigger a contagion effect affecting all States, regardless of their fiscal merit. It was stated that 'bankruptcy for States would cripple the bond markets and '[p]ermitting States to break their promises to bondholders would decrease investor confidence and damage States' ability to invest in much-needed infrastructure'.[90] The problem, once again, lay in the fact that fiscal issues where confined to only few States:

> The municipal bond market is now responding to legitimate concerns about the long-term structural imbalances in these six to eight States. But I believe we would be correct to distinguish these bad apples from the other 40-some States that have been relatively well managed and only have temporary deficits. That is why a one size-fits-all approach like bankruptcy for States could do more harm than good.[91]

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[85] Abel (n 70) 413. In this vein, see Erik Jones, 'The Politics of NGEU', *REBUILD Launch Conference* (24 February 2022), which stated that ESM reliance was beginning to become 'toxic'.
[86] Kolb (n 14) 6.
[87] David Skeel, 'States of Bankruptcy' (2012) 79 The University of Chicago Law Review 677; Abel (n 70) 408.
[88] Peter Spiegel, 'Trichet Warns on Bail-out System Dangers' (*Financial Times*, 29 October 2010) <https://www.ft.com/content/cba1de4a-e37c-11df-8ad3-00144feabdc0> accessed 10 December 2023.
[89] Jonathan Henes and Stephen Hessler, 'Deja Vu, All Over Again' (*New York Law Journal*, 27 June 2011) <https://www.kirkland.com/-/media/publications/article/2011/06/deja-vu-all-over-again/newyorklawjournal_june-2011.pdf> accessed 10 December 2023.
[90] Hearing of the Courts, Commercial and Administrative Subcommittee of the House Judiciary Committee 'Role of Public Employee Pensions in Contributing to State Insolvency and the Possibility of a State Bankruptcy Chapter' (14 February 2011) <https://www.govinfo.gov/content/pkg/CHRG-112hhrg64585/html/CHRG-112hhrg64585.htm> accessed 10 December 2023.
[91] Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs of the Committee on Oversignt and Government Reform, 'State and Municipal Debt: The Coming Crisis?' (9 February 2011)

This argument relies on misguided assumptions: firstly, that the market does not differentiate between financially sound Member States and those at risk of default and, secondly, that the negative effects will be significant and enduring.[92]

From a theoretical perspective, the impact on costs could go either way. Sovereign debt contracts are challenging to enforce and willingness to pay is closely linked to default costs. Thus, improving a system to reduce such costs might not only diminish incentives for contractual compliance but also increase investment risk, subsequently raising borrowing costs. Conversely, excessive accumulation of debt and delayed default could result in loss of value and overborrowing, further deteriorating sovereign risk profile and bond yields. Addressing these concerns could potentially lead to lower costs.[93]

However, from an empirical viewpoint, the hypothesis lacks a solid foundation. Concerning the market's ability to differentiate, evidence from the US municipal bond market demonstrates that markets function to a significant degree with proper differentiation.[94] Contagion and inadequate differentiation is frequently exemplified with the Orange County filing for municipal bankruptcy in 1994 after defaulting on debt,[95] which triggered a market-wide decrease in the value of bonds without direct exposure to it. Nevertheless, it is important to note that the bankruptcy option has been available since the 1930s, making it more likely that the reaction was due to the default itself, rather than the mere existence of the bankruptcy option. Additionally, this effect only lasted for one day,[96] making it more difficult to suggest a causal relationship for justifying the avoidance of a particular public policy.

A proper restructuring procedure would also contribute to enhance risk assessment and country differentiation in the EU, thus enhancing markets' ability to distinguish between high(er) and low(er) borrower quality and adjust premiums accordingly. As Paulus argues,

> in the beginning there is likely to be a mess when and if the new set of rules were introduced here and now. However, it would be wrong to assume that this messy situation would last forever.[97]

On the contrary, a transparent and predictable process mitigates chaotic market reactions and fosters market discipline on Member States, since all participants know which rules to follow. In this way, it can significantly contribute to the stability of the EU as a whole and promote price stability as long as the ECB refrains from intervening in the secondary bond market, effectively monetising national public debts and deficits.

<https://www.govinfo.gov/content/pkg/CHRG-112hhrg68362/pdf/CHRG-112hhrg68362.pdf> accessed 10 December 2023.

92 Skeel, 'States of Bankruptcy' (n 87) 718.

93 Panizza (n 72) 229.

94 See Municipal Bonds Screener (*MunicipalBonds.com*) <https://www.municipalbonds.com/screener/#sort_by=yield&sort_direction=asc&page=3> accessed 10 December 2023.

95 John Halstead, Shantaram Hedge, and Linda Klein, 'Orange County Bankruptcy: Financial Contagion in the Municipal Bond and Bank Equity Markets' (2004) 39 The Financial Review 293, 313.

96 Skeel, 'States of Bankruptcy' (n 87) 720.

97 Christoph Paulus, 'A Resolvency Proceeding for Defaulting Sovereigns' in Patrick S Kenadjian, Klaus-Albert Bauer and Andreas Cahn (eds), *Collective Action Clauses and the Restructuring of Sovereign Debt* (De Gruyter 2013) 181, 189.

Regarding other implemented solutions resembling limited restructuring mechanisms, such as CACs, there is a significant amount of evidence that these clauses did not result in additional borrowing costs when compared to non-CAC bonds,[98] suggesting that restructuring options do not cause contagion.

Regarding significance and durability of costs, sovereign defaults generally have no substantial negative impact on subsequent growth, as they often mark the final stage of a crisis and the beginning of economic recovery.[99] In fact, there is a growing body of evidence indicating that the costs associated with sovereign debt restructuring are neither very severe[100] nor long-lasting.[101]

4 CONSTITUTIONAL ADMISSIBILITY

A debt restructuring mechanism is essentially a process designed to restore financial viability to its subject, through various measures such as reducing the overall amount of principal, decreasing interest rates, setting a new deadline for payments, among other types of measures. In any case, the debtor will emerge with improved and more advantageous financial circumstances.

The features of this framework pose challenges under EU law, primarily due to the existence of the prohibition of monetary financing in Article 123 TFEU and the no-bail out clause in Article 125 TFEU. The common aim of these provisions is to ensure that the correct incentives are in place for Member States to pursue sound budgetary policies.[102] In foreseeing the ECB should refrain from purchasing debt in primary markets and that neither the EU nor the Member States shall be liable for or assume each other's commitments, the question arises as to whether a scenario of financial relief, with their institutional involvement, would be a possible outcome. From this perspective, relief from the original conditions of the purchase on the (secondary) market might be interpreted as monetary financing of Member State(s), since it would alleviate budgetary pressures.

Similarly, the teleology of Article 125 TFEU is to promote sound budgetary policies. In this regard, Maduro argues that this objective would be endangered only if the EU or Member States become legally responsible for the debt of other Member States, in which case the practice would be in violation of the Treaty. This would not be the case if financial assistance was provided voluntarily to a Member State, which is no longer capable of fulfilling its commitments. In this scenario, neither the EU nor the Member States are ex ante assuming any liability or committing to the obligations of that Member State towards others. In fact, it would create a bilateral relationship with the creditor, who would independently decide on the debt relief.[103]

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[98] Abel (n 70) 411; Fang, Schumacher, and Trebesch (n 50) 120.

[99] Eduardo Yeyati and Ugo Panizza, 'The Elusive Costs of Sovereign Defaults' (2011) 94 Journal of Development Economic 95.

[100] Kevin Kordana, 'Tax Increases in Municipal Bankruptcies' (1997) 83 Virginia Law Review 1035, 1074; Richard Schragger, 'Democracy and Debt' (2012) 121 The Yale Law Journal 860, 874.

[101] Ugo Panizza, Federico Sturzenegger, and Jeromin Zettelmeyer, 'The Economics and Law of Sovereign Debt and Default' (2009) 47 Journal of Economic Literature 651, 664.

[102] See Jörn Axel Kämmerer, 'Article 123 (Ex Article 101 TEC) [Prohibition of Credit Facilities]' in Helmut Siekmann (ed), *The European Monetary Union* (Hart Publishing 2022) 155.

[103] Miguel Poiares Maduro, 'EU Law and Sovereign Debt Relief' in Koen Lenaerts et al (eds), *An Ever-Changing Union? Perspectives on the Future of EU Law in Honour of Allan Rosas* (Hart Publishing 2020) 75, 77-78. In contrast,

Moreover, the CJEU has ruled that the ESM is not incompatible with Article 125 TFEU. This decision was based on the necessity of financial assistance to ensure the financial stability of the Eurozone as a whole and because of the attached conditionality.

Importantly, there are two sides, or different moments in the legal relationship between a creditor and a debtor. Granting financial assistance marks the initial moment, where the relationship begins and legal obligations are defined for both parties. This was the side the Court focused on in *Pringle* to ensure that, from the outset, the objective of maintaining sound budgetary policies in Member States through market pressure was preserved.

However, there is another side to the creditor-debtor relationship, which involves the fulfilment of obligations by the debtor, most notably the repayment of funds. The CJEU did not analyse the relationship from this perspective. Nevertheless, there is a risk of non-performing loans, situations where debtors may not be able to meet their repayment obligations. The question arises whether, at the outset, debtors are aware, or can reasonably assume, that their debts will be written off at some point. However, this matter relates to maintaining pressure over Member States' budgetary policy, not to debt relief. Viewed from this perspective, debt relief by EU institutions or Member States may or may not be contrary to the treaties, depending on whether the debtor is aware of the creditors' intentions before entering into such debt. If there is no such prior knowledge, debt relief should be permitted under EU law. In fact, in the *Gauweiler* case, the Court argued that potential ECB exposure to losses would not, in itself, reduce market discipline.

The lack of awareness of original creditors' intentions may not be as straightforward as it may seem. Crucially, the ECB's asset purchase programs were designed to operate as unpredictably as possible. Nevertheless, the intervention of the ECB was not a matter of *if* but a matter of *when*, given that preventing the break-up of the Eurozone became one of the ECB's *de facto* objectives. Concomitantly, if one of the main objectives in granting financial assistance is to preserve financial stability within the Euro area, a similar logic may underlie it.

In this context, Maduro argues that the form and extent of debt relief are not irrelevant. In fact, the more substantial the debt relief, the harder it becomes to demonstrate that conditionality-based financial aid represents a functional equivalent. Debt relief, particularly a haircut, reduces the incentive to consolidate budget policies and can heighten moral hazard. Hence, to preserve market discipline, differentiated credit risk needs to be maintained. In addition, conditionality must be in place to offset the fact that market funding will not be needed during the assistance period.[104]

However, the relevance of the form and extent of debt relief must be assessed not so much by focusing on these two features, but by considering the type of procedure set up for debt restructuring. In essence, moral hazard is a cognitive process by which the subjects anticipate that present actions will be replicated in the future. The form and extent of debt relief provide limited information about creditors' future decisions. What truly informs us

see Christoph Ohler, 'Article 125 (Ex Article 103 TEC) [Prohibition to Assume Liabilities]' in Helmut Siekmann (ed), *The European Monetary Union* (Hart Publishing 2022) 181, 188, which argues that for the 'assumption' definition to be covered it is irrelevant whether the support is given unilaterally on a voluntary basis by one Member State or due to an agreement between Member States. However, Article 125 does not cover loans but also the purchasing of bonds on the primary market by other Member States if they are conducted under market conditions.

[104] Maduro, 'EU Law and Sovereign Debt Relief' (n 103) 81.

about the likelihood of decision-replication is how such decisions are carried out. At this point, it could be applied what was discussed above: the current process of verticalisation within the EU has increasingly shed light on what those future decisions might resemble, such as the dominance demonstrated by the ECB in Member States' debt markets, as well as the overly prescriptive approach of the EU economic governance framework, which reduces national ownership of economic policy and encourages supranational assistance.

Conversely, a process based on a debt restructuring framework would offer enhanced legal certainty for both creditors and debtors, creating a legal relationship with market actors, which discourages future fiscal recklessness. Crucially, national fiscal policies would come under closer scrutiny by the market. Their willingness to provide more or less funding would, thus, be proportional to the degree of success or failure each Member State demonstrates in conducting their economic policies. Similarly, the readiness to undertake restructuring would reduce the likelihood of future funding being granted which, in turn, would reduce moral hazard. Ultimately, the anticipation of a debt restructuring process would enhance fiscal responsibility and diminish the threat of restructuring.

In light of the above, debt relief would be acceptable within the framework of the case-law and would be compatible with current Treaty provisions, especially Articles 123 and 125 TFEU.

5 DEMOCRATIC NECESSITY

The previous section discussed the costs associated with sovereign debt default and restructuring, highlighting the challenges they pose while emphasizing that they are not insurmountable.[105] However, in a world of imperfect alternatives, these costs should only be considered excessive if there are less burdensome options available.[106] As seen above, bailouts are one option, which takes place outside the market realm, but they bring about significant costs on financial, economic, social and political levels in the short-to-long-term. At the same time, there is a substantial risk that bailouts leave the underlying issues of fiscal responsibility and debt overhang unresolved.

In the context of the EU, there are other reasons that might favour the implementation of a bankruptcy procedure and shed light on how the Union can achieve a better balance from a democratic and accountability perspective.

There is a well-established body of literature, which argues for a democratic deficit in the EU, primarily stemming from deficient (or complete absence of) national internalisation of interdependency costs.[107] Functionalistic and instrumental approaches have the critical

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[105] A good overview on sovereign default costs is given by Bianca De Paoli, Glenn Hoggarth, and Victoria Saporta, 'Output Costs of Sovereign Default' in Robert Kolb (ed), *Sovereign Debt: From Safety to Default* (Wiley 2011) 23. See also Adam Feibelman, 'American States and Sovereign Debt Restructuring' in Peter Conti-Brown and David Skeel (eds), *When States Go Broke: The Origins, Context, and Solutions for the American States in Fiscal Crisis* (Cambridge University Press 2012) 146, 172.

[106] Clayton P Gillette, 'What States Can Learn From Municipal Insolvency' in Peter Conti-Brown and David Skeel (eds), *When States Go Broke: The Origins, Context, and Solutions for the American States in Fiscal Crisis* (Cambridge University Press 2012) 108.

[107] Miguel Poiares Maduro, 'A New Governance for the European Union and the Euro: Democracy and Justice' (2012) Robert Schuman Centre for Advanced Studies Policy Paper 2012/11 <https://cadmus.eui.eu/bitstream/handle/1814/24295/RSCAS_PP_2012_11rev.pdf?sequence=1&isAllowed=y> accessed 10 December 2023; Fritz W Scharpf, 'Democratic Legitimacy under Conditions of Regulatory

shortcoming of presenting solutions for EU integration as inevitable to the maintenance of a flawed political project, notably the Euro. The functionalistic approach, as developed by EU institutions, is one of the reasons why Member States later opted for a more intergovernmental method within the European Council regarding economic policy, rather than furthering supranational economic policies, for instance by restructuring the EU budget.

With Lindseth's perspective in mind, EU integration should not be purely technocratic. Instead, it should be viewed as a democratic process, where the supranational solution is seen as suitable substitute, in a democratic sense, for reducing national politics.[108] In a way, it seems that the 'legacy costs' of an originally flawed EMU have been primarily shouldered by the so-called debtor countries, which is not consistent with the shared democratic responsibility each Member State embodies in such an endeavour.[109]

Even if the democratic identity in the EU has slowly been emerging, allowing for the existence of an emergency government (or governance) in the absence of a sovereign state,[110] this relationship needs to work both ways and be effectively owned by each Member State. Merely signing an international treaty, which obliges states to pass a national law or constitutional amendments to introduce balanced budget rules is insufficient, as this process will always be seen as externally-driven and, to some extent, imposed during times of financial hardship. This context is hardly conducive to facilitating a national debate on whether a 'golden rule' should be introduced. From this perspective, it may be untenable to continue pursuing supranational economic coordination whose output is to impose and ensure compliance with budgetary restrictions, as is the case with the EU economic governance framework and financial assistance programmes. This paradigm places a heavier burden on the so-called 'debtor countries', as they are the ones more likely to face financial constraints and need to introduce restrictions.

Another challenging hurdle to overcome in EU economic integration is the fear of becoming a 'transfer union', meaning the establishment of a system of permanent and continuous financial transfers from more developed to less developed Member States. From the perspective of 'creditor countries', this not only generates moral hazard, but essentially creates a system with little accountability and responsibility leading to financially dependent states in the long term.

Hence, beyond providing financial grants to Member States in need, there are concerns about consolidating a transfer-dependency system. This is yet another reason to consider a market-based process within a new EU federal consensus. If triggered, sovereign debt restructuring would be conducted through a legally binding process, providing legal certainty. While certain Member States and EU institutions would have to bear some losses, these

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Competition: Why Europe Differs from the United States' in Kalypso Nicolaidis and Robert Howse (eds), *The Federal Vision: Legitimacy and Levels of Governance in the United States and the European Union* (Oxford University Press 2001); Simon Hix and Bjørn Høyland, *The Political System of the European Union* (3rd edn, Bloomsbury Publishing 2011).

[108] Peter Lindseth, 'Thoughts on the Maduro Report: Saving the Euro Through European Democratization?' (*EUtopialaw*, 13 November 2012) <https://eutopialaw.wordpress.com/2012/11/13/1608/> accessed 10 December 2023.

[109] Peter Lindseth, 'Power and Legitimacy in the Eurozone: Can Integration and Democracy Be Reconciled?' in Maurice Adams, Federico Fabbrini, and Pierre Larouche (eds), *The Constitutionalization of European Budgetary Constraints* (Bloomsbury Publishing 2014) 379.

[110] Signe Rehling Larsen, *The Constitutional Theory of the Federation and the European Union* (Oxford University Press 2021) 149.

would be internalised in both creditor and debtor countries' political processes. The major difference lies in the certainty that transfer dependency was severed, the no-bail out clause reassured, individual responsibility bolstered, and market confidence restored. This confidence is not only in the sense that Member States whose debt is being restructured would be in better financial conditions, but also because each market participant would have the incentive to scrutinise national economic policy sustainability and make actual risk differentiation.[111]

6 CONCLUSION

At the beginning of EMU integration, fiscal compliance was expected to be delivered through market forces. However, with the financial crisis, the focus has shifted towards developing economic governance through the political process, as evident from the increased economic surveillance in the fiscal and economic domains.

According to the perspective of the writer, this change in approach stemmed from an inadequate assessment of the causes of market failure. The mispricing of Member States' sovereign debt was more a symptom of a flawed design than a mistake in choosing the market process. This article, therefore, has reevaluated this approach, by examining the feasibility of a debt restructuring framework.

By addressing some of the main challenges often associated with this option, the conclusion is that, in a world of imperfect alternatives, the benefits outweigh the associated risks. Most importantly, a debt restructuring framework would increase the participation, as scrutiny of economic and fiscal policies would become distributed throughout market participants rather than being confined to the political process.

While this increase in participation might raise the complexity, it is argued that it would yield better results in terms of Member States' financial autonomy and sustainability, and addressing democratic concerns. Importantly, this approach aligns with the principle of subsidiarity, which calls for action to be placed at the most effective level of governance.

[111] In the same vein see Jeromin Zettelmeyer, 'Ist Der Euro Noch Zu Retten? - Vorschläge Für Eine Neue Europäische Wirtschaftspolitik' (*politik für europa*, 2017) 11 <https://library.fes.de/pdf-files/id/ipa/12819.pdf> accessed 10 December 2023.

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OPERATIONALISATION OF THE RULE OF LAW

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The European Union is an international organisation, a derivative structure, the existence of which depends on its Member States. It is an economic and political entity as well as a community of values, but first and foremost, it is a legal entity. It is a community of law, and it is only through the compliance of all states and the EU itself with values, principles, and rules, including the rule of law, that this non-state entity exercising public authority is able to function and develop. And even if the Treaty on the European Union did not encompass the rule of law, the latter would still apply as a general principle of EU law derived from the constitutional traditions common to its Member States. In the EU, the rule of law has been elevated to the rank of a value, a leading axiological category underpinning the entire structure – an element of European constitutional identity. Based on the recent jurisprudence, the article shows how the rule of law as a value enshrined in Article 2 TEU, has been operationalized by the Court of Justice. On the one hand, there is a judicial mechanism to the extent that other provisions of the treaty and secondary law confirm this competence, while on the other, there is a political mechanism applicable in matters not covered by substantive EU law. In the EU, the judicial mechanism is by far the most effective of the two, while the political mechanism does not work as its effectiveness depends on the goodwill and cooperation of the Member States.

1 INTRODUCTORY REMARKS

> *As the EU is a 'Union based on the rule of law', it establishes a multilevel system of governance of laws, not men.*[1]

The rule of law is an analytical category, which, in principle, should be an inherent feature of national constitutions. However, as it turns out, this does not necessarily have to be the case. This is due to the fact that a reference to the rule of law can also be found in the founding documents, i.e. treaties of international law, of certain non-state entities. One such non-state entity is the European Union (hereinafter: EU), an international organization exercising public authority. Applying a domestic analogy, we can even say that the EU exercises legislative, executive, and judicial powers derived from its competences previously reserved for the Member States.

It ought to be pointed out that the rule of law, as a value enshrined in Article 2 TEU, is an abstract category, which requires substantiation – or operationalisation as some wish to call it. Operationalization of Article 2 TEU not only entails the substantiation of this abstract

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[1] Koen Lenaerts, 'On Checks and Balances: The Rule of Law within the EU' (2023) 29(2) Columbia Journal of European Law 28.

category, i.e. its translation into principles and rules (operationalisation *sensu stricto*) but also, and perhaps even more so, its enforcement (operationalisation *sensu largo*). This, in turn, should help promote good governance, and, as a consequence, the smooth functioning of the entire supranational structure.

To ensure state compliance with values (themselves a somewhat vague category), their operationalization is required. One of the principles comprising the rule of law as a value is the independence of the judiciary, which follows from Article 19(1) subparagraph 2 TEU. At the present time, the judicial mechanism provided for under Articles 258, 259 and 267 TFEU seems to be the most effective means of its enforcement, as opposed to the political mechanism provided for in Article 7 TEU, the effectiveness of which depends on the goodwill of the Member States.

This article begins with some remarks on the rule of law, followed by an analysis of the judgment in the case *Associação Sindical dos Juízes Portugueses* together with its implications, a discussion of the various ways in which the rule of law is protected, as well as some concluding remarks. The research area is limited to the EU and its Member States. The research problem itself comes down to the question of how the rule of law can be operationalised in a non-state, i.e. supranational context. In turn, the research questions focus on the role of institutions in operationalizing the rule of law, the various ways of protecting this very value and, in particular, the role of the Court of Justice (hereinafter: CJEU/Court) in this process.

So far, numerous studies have been devoted to the rule of law[2] and jurisprudence on this matter,[3] above all to the case of *Associação Sindical dos Juízes Portugueses* – one of the most important rulings in the history of European integration. Hence, why is there a need for another study addressing this issue? It needs to be pointed out that the rule of law not only remains a relevant topic involving many important issues demanding resolution but is also a very sensitive one. Hence, there are a variety of ways of dealing with it. For the purpose of the present study the following thesis was adopted: the ruling in the Portuguese case stemmed from the pressing circumstances of the time, i.e. the urgent need to counteract systemic violations of the rule of law and opened the way for the Court to apply a judicial mechanism.

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[2] There is a lot of literature on the subject, see e.g.: András Jakab and Dimitry Kochenov (eds), *The Enforcement of EU Law and Values: Ensuring Member State Compliance* (Oxford University Press 2017); Carlos Closa and Dimitry Kochenov (eds), *Reinforcing the Rule of Law Oversight in the European Union* (Cambridge University Press 2016); Laurent Pech, 'Article 7 TEU: From "Nuclear Option" to "Sisyphean Procedure"?' in Uladzislau Belavusau and Aleksandra Gliszczynska-Grabias (eds), *Constitutionalism under Stress* (Oxford University Press 2020); Barbara Grabowska-Moroz et al, 'Reconciling Theory and Practice of the Rule of Law in the European Union' (2022) 14(2-3) Hague Journal on the Rule of Law 101; Kim Lane Scheppele et al, 'EU Values Are Law, after All: Enforcing EU Values through Systemic Infringement Actions by the European Commission and the Member States of the European Union' (2020) 39 Yearbook of European Law 3; Koen Lenaerts, 'Upholding the Rule of Law through Judicial Dialogue' (2019) 38 Yearbook of European Law 3.

[3] See e.g.: Aida Torres Pérez, 'From Portugal to Poland: The Court of Justice of the European Union as watchdog of judicial independence' (2020) 27(1) Maastricht Journal of European and Comparative Law 105; Laurent Pech and Sébastien Platon, 'Judicial independence under threat: The Court of Justice to the rescue in the ASJP case' (2018) 55(6) Common Market Law Review 1827; Matteo Bonelli and Monica Claes, 'Judicial serendipity: How Portuguese judges came to the rescue of the Polish judiciary' (2018) 14(3) European Constitutional Law Review 622.

2 RULE OF LAW – GENERAL REMARKS

The rule of law is both a fundamental principle and a value defined by treaty,[4] which underpins democratic societies and ensures the protection of individual rights and liberties. While it is a political concept, it is first and foremost a legal one. However important the rule of law may be, until recently it lacked a legal definition. Hence, efforts have been made to specify and substantiate this very term. The first institution to tackle the problem was the European Commission (hereinafter: EC/Commission) (2014),[5] followed later by the European Parliament (hereinafter: EP/Parliament) and the Council of the EU (hereinafter: Council) (2020). The first attempt to provide a legal definition of the rule of law came with the 'conditionality' regulation adopted by the EP and Council. In the said regulation we read:

> the rule of law refers to the Union value enshrined in Article 2 TEU. It includes the principles of legality implying a transparent, accountable, democratic and pluralistic law-making process; legal certainty; prohibition of arbitrariness of the executive powers; effective judicial protection, including access to justice, by independent and impartial courts, also as regards fundamental rights; separation of powers; and non-discrimination and equality before the law. The rule of law shall be understood having regard to the other Union values and principles enshrined in Article 2 TEU.[6]

However, some Member States, while not necessarily questioning the very existence of the rule of law as a value at the EU level, are at least trying to assign it their own meaning and understanding in line with national traditions. And this is where, among other things, a problem arises, for, as a rule, national traditions refer to a state, which the EU is not.[7] And since the rule of law was not included in the founding treaties (Treaty of Paris (1951), Treaties of Rome (1957)), the task of introducing this principle into the EU legal order, or value as it is defined in the treaty, i.e. establishing its meaning and understanding (or its manifestations)[8] as a general principle of EU law, fell to the CJEU.

A reference to the principle of the rule of law to which all Member States are bound as well as to the goal of the Community and Union regarding external development policy and common security and defence policy can already be found in the Treaty of Maastricht.[9] Later, the Treaty of Amsterdam (hereinafter: TA) contained a catalogue of principles on which the EU was based, among them the rule of law.[10] However, greater emphasis was

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[4] See Article 2 TEU.

[5] See European Commission, 'Communication from the Commission to the European Parliament and the Council: A new EU Framework to strengthen the Rule of Law' COM (2014) 0158 final.

[6] See Regulation (EU, Euratom) 2020/2092 of the European Parliament and of the Council of 16 December 2020 on a general regime of conditionality for the protection of the Union budget [2020] OJ L 433I/1 (Conditionality Regulation) Art 2.

[7] There are two leading traditions, namely German *Rechtsstaat* and French *état de droit*, see Danuta Kabat-Rudnicka, 'The rule of law in the national and supranational context' (2023) 2023(2) Przegląd Europejski 9; Martin Sunnqvist, '"EU's legal history in the making". Substantive Rule of Law in the Deep Culture of European Law' (2023) 45(1) Giornale di Storia costituzionale 5.

[8] See Case C-64/16 *Associação Sindical dos Juízes Portugueses v Tribunal de Contas* EU:C:2018:117 para 35, where the Court refers to the principle of the effective judicial protection of individuals' rights under EU law as a general principle of EU law stemming from the constitutional traditions common to the Member States.

[9] See Preamble to the TEU, Article 130u TEC and Article J1 TEU.

[10] See Article 6(1) TEU.

placed on the rule of law in the Treaty of Lisbon (hereinafter: TL) which contains the catalogue of values underlying the Union, including the rule of law. In Article 2 TEU we can read: 'The Union is founded on the values of respect for human dignity, freedom, democracy, equality, the rule of law and respect for human rights, including the rights of persons belonging to minorities'.

The Treaty on the EU (hereinafter: TEU) in the Lisbon version refers to the rule of law – the term having been 'borrowed' from the constitutional law (or rather constitutional traditions) of the Member States, abandoning in this way the term earlier used by the CJEU, which, however, seems more appropriate, i.e. less controversial, namely a community of law.[11] It is also worth noting that the catalogue of values was placed at the very beginning of the TEU, which proves not only the importance the authors (high-contracting parties) attached to axiology, but also that the entire 'edifice' is founded on values the EU and its Member States should respect in all their activities. Such a positioning resembles the structure of national constitutions, which usually place guiding principles at the very beginning, i.e. in the preamble and in the very first articles, i.e. principles, which regulate the most prominent issues – cardinal issues as some would argue – for the entire legal order, and which constitute its very foundation. And unlike the TA, which refers to principles, the TL refers to values. What is more, the Charter of Fundamental Rights (hereinafter: CFR/Charter) refers to the principles of democracy and the rule of law on which the Union is founded, as opposed to the values of human dignity, freedom, equality, and solidarity.[12]

As has already been said, the rule of law is a value; however, it is also a general principle of EU law. It is a constitutional principle[13] and an axiological norm. Not only does it require laws to be clear, transparent, and applied equally to everyone within *ex ante* defined limits but it also requires an independent judiciary and effective law enforcement – a value (principle) which is to be respected and adhered to by both the Member States and the EU itself. In other words, on the one hand, it is about accountability and, on the other, about guarantees regarding its enforcement.

It should be pointed out that respect for the rule of law has become an even more pressing issue following the establishment of the area of freedom, security, and justice (hereinafter: AFSJ) under the TL. The point namely is that the absence of judicial independence will cause national courts to lose confidence in one another, which will, in turn, lead to the fragmentation of the AFSJ.[14] Also – according to Koen Lenaerts – with the disappearance of internal borders in Europe the long arm of the law should take on a supranational dimension.[15] What is more, because the EU's constitutional structure would

[11] In one of the Court's first judgments we read: 'the European Economic Community is a Community based on the rule of law' - Case 294/83 *Parti écologiste 'Les Verts' v European Parliament* EU:C:1986:166 para 23.
[12] See Preamble to the Charter of Fundamental Rights of the European Union [2012] OJ C326/391, and also Jacek Barcik, *Ochrona praworządności w Radzie Europy i Unii Europejskiej ze szczególnym uwzględnieniem niezależności sądów i niezawisłości sędziów* (C.H. Beck 2019) 107.
[13] See Laurent Pech, "'A Union Founded on the Rule of Law': Meaning and Reality of the Rule of Law as a Constitutional Principle of EU Law' (2010) 6(3) European Constitutional Law Review 359.
[14] See Koen Lenaerts, 'On Values and Structures: The Rule of Law and the Court of Justice of the European Union' in Anna Södersten and Edwin Hercock (eds), *The Rule of Law in the EU: Crisis and Solutions* (Swedish Institute for European Policy Studies 2023) 15.
[15] See Lenaerts, 'On Checks and Balances' (n 1) 43.

fall apart in the absence of the rule of law, two essential conditions for a Member State's participation in this structure are value alignment and prohibition of value regression.[16]

What makes the rule of law special is the fact that it has become a dominant organisational paradigm of modern constitutional law not only in Member States but also in the EU as a whole – a meta-principle which provides the foundations for an independent and effective judiciary and justifies the subjection of public power to formal and substantive legal constraints.[17]

3 RULE OF LAW IN NEED OF OPERATIONALISATION

It is worth noting that enforcing values is a challenging task, hence the need for operationalizing them. In the context of the rule of law, it entails the translation of this abstract concept into not only principles and rules but also into practical measures facilitating their enforcement.

The rule of law means that all public authorities must operate within the limits of the law, i.e. they are bound by legal norms which are beyond their control.[18] It also means the subordination of arbitrary power to laws and the containment of the guardians of the law to serve the interests of the law, i.e. the interest of the whole community.[19]

In the EU, the rule of law has become one of these issues, which is the subject not only of legal and political debate, but also of in-depth analysis.[20] The rule of law is a constitutional principle characterized by both formal and substantive elements. However, the doctrine also entails a three-fold division into formal, procedural, and substantive components, emphasizing that it involves not only compliance with the law but also ensuring that the content meets the standards of liberal democracies. What is more, it is inextricably linked to democracy and fundamental rights,[21] as one cannot exist without the other.

In the EU, it was primarily the Court which identified and developed key elements defining the rule of law. In the *Les Verts* case, the Court held that, in a Community based on the rule of law, the Member States and their institutions are subject to scrutiny to ensure that the measures they adopt comply with the treaty.[22] In turn, in the *Openbaar* case, we can read that the judiciary should be distinguished from the executive, in accordance with the principle of separation of powers which characterises the rule of law.[23] And in the most important ruling to date – the *Associação Sindical* case – the Court held that the very existence of effective

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[16] ibid 54.

[17] Laurent Pech, 'The Rule of Law as a Well-Established and Well-Defined Principle of EU Law' (2022) 14(2-3) Hague Journal on the Rule of Law 124.

[18] Werner Schroeder, 'The Rule of Law as a Value in the Sense of Article 2 TEU: What Does It Mean and Imply?' in Armin von Bogdandy et al (eds), *Defending Checks and Balances in EU Member States* (Springer 2021).

[19] Mortimer N S Sellers, 'What Is the Rule of Law and Why Is It So Important?' in James R Silkenat et al (eds), *The Legal Doctrines of the Rule of Law and the Legal State (Rechtsstaat)* (Springer 2014).

[20] See also Jens Meierhenrich and Martin Loughlin (eds), *The Cambridge Companion to the Rule of Law* (Cambridge University Press 2021); Dimitry Kochenov et al, 'Introduction: The Great Rule of Law Debate in the EU' (2016) 54(5) Journal of Common Market Studies 1045; Amichai Magen, 'Cracks in the Foundations: Understanding the Great Rule of Law Debate in the EU' (2016) 54(5) Journal of Common Market Studies 1050.

[21] We find a similar reference in the Preamble to the Convention for the Protection of Human Rights and Fundamental Freedoms, signed in Rome on 4 Nov. 1950, European Treaty Series - No. 5.

[22] *Parti écologiste 'Les Verts'* (n 11) para 23.

[23] Case C-477/16 *Openbaar Ministerie v Ruslanas Kovalkovas* EU:C:2016:861 para 36.

judicial review to ensure compliance with EU law is of the essence of the rule of law.[24] The Court also acknowledged key elements of the rule of law, including the principles of legality,[25] legal certainty,[26] and the protection of legitimate expectations.[27]

As evident, the rule of law is an integral facet of the EU legal order.

4 WAYS TO PROTECT THE RULE OF LAW

There are at least three ways in which the rule of law is protected. The first, and the least effective of these is the political mechanism for monitoring compliance with the rule of law, namely the procedure provided for under Article 7 TEU. As the Hungarian and Polish cases show, this procedure is not a sufficient measure for preventing serious breaches of the rule of law by Member States. What makes this procedure unique is the fact that it tries to reconcile sanctions with respect for sovereignty,[28] which is an extremely difficult, if not impossible task.

The procedure introduced by Article 7 TEU is complex, rigid, and difficult to initiate as it depends on the political will of the Member States, and most importantly, has a built-in intergovernmental component.[29] And it is because of the difficulties involved in its application that it became necessary to look for other ways. To this end, in March 2014 the Commission issued a communique entitled *A new EU Framework to strengthen the Rule of Law*, the main objective of which is to address systemic threats to the rule of law. According to the communique, the following must be under threat:

> The political, institutional and/or legal order of a Member State as such, its constitutional structure, separation of powers, the independence or impartiality of the judiciary, or its system of judicial review including constitutional justice […] as a result of the adoption of new measures or of widespread practices of public authorities and the lack of domestic redress. The Framework will be activated when national 'rule of law safeguards' do not seem capable of effectively addressing those threats.[30]

As can be seen, this instrument is intended to be triggered when a Member State's authorities take measures or tolerate situations, which may systematically and adversely affect the integrity, stability, or the smooth functioning of institutions and mechanisms aimed at protecting the rule of law.[31]

The other two instruments are judicial in nature. The CJEU can review compliance with the rule of law in two other ways, namely by direct action (complaint) – an instrument provided for in Articles 258 and 259 TFEU and by non-complaint proceedings – preliminary questions from national courts pursuant to Article 267 TFEU.

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[24] *Associação Sindical dos Juízes Portugueses* (n 8) para 36.
[25] Case C-303/05 *Advocaten voor de Wereld* EU:C:2007:261 paras 49-50.
[26] Case C-550/07 P *Akzo Nobel Chemicals and Akcros Chemicals v Commission* EU:C:2010:512 para 100.
[27] Case C-362/12 *Test Claimants in the Franked Investment Income Group Litigation* EU:C:2013:834 para 44.
[28] See Barcik (n 12) 152.
[29] ibid.
[30] Commission, 'A new EU Framework to strengthen the Rule of Law' (n 5) point 4.1.
[31] ibid.

With regard to direct action and prior to the ruling in the *Associação Sindical* case, it was not clear whether the judicial route provided for in Article 258 TFEU could be used to protect the rule of law in connection with the independence of the judiciary and judges. The question namely was whether Article 19 TEU, which obliges Member States to introduce measures necessary to ensure effective judicial protection in areas covered by EU law may constitute an independent legal basis for a complaint where no other norm of EU substantive law is alleged to have been breached.[32] Following the Court's judgment, Article 258 TFEU can be used, in parallel with, and independently of Article 7 TEU,[33] to protect the independence of national courts and judges. In other words, the issue at stake is judicial independence, the independence of which is a precondition for any judicial dialogue between EU courts and national courts.

As for non-complaint proceedings under Article 267 TFEU, it needs to be said that until 2018 the preliminary ruling instrument was not used as a means of protecting the rule of law in the case of judicial independence and the impartiality of judges. The reason was that the question referred to the Court must concern an interpretation of EU law, and hence when submitting a question, a national court had to indicate a substantive (material) norm of EU law. Since the organization of the judiciary does not fall within the catalogue of competences transferred to the EU, it could not be the subject of a request for a preliminary ruling – an approach that has been changed following the judgment in the case of *Associação Sindical*. When ruling on the case, the Court decided to refer only to Article 19(1) TEU, thus significantly expanding the scope of legal protection. *Ipso facto* Article 19(1) TEU has become an independent legal basis for assessing allegations regarding possible failures in ensuring effective judicial protection, including legal regulations not related to the application of EU law but falling within the fields covered by EU law.[34]

In summary, it can be argued that the intellectual construction adopted by the CJEU 'revolutionizes' the way in which the rule of law is protected in the EU. More importantly, in addition to the centralized model provided for in Articles 258 and 259 TFEU, and above all in Article 7 TEU, it is now possible for national courts to provide decentralized judicial protection.[35] What is more, the way in which the values under Article 2 TEU have been operationalised is not only a manifestation of how the EU functions as a polity but also

[32] In Case C-619/18, the first direct action for an infringement under Article 258 TFEU on the compatibility of certain measures taken by a Member State concerning the organisation of its judicial system, the Commission, when launching the procedure referred to Article 19 TEU and Article 47 CFR; see Case C-619/18 *European Commission v Republic of Poland* EU:C:2019:531. It was AG Tanchev who in his opinion stated: 'Article 19(1) TEU constitutes an autonomous standard for ensuring that national measures meet the requirements of effective judicial protection, including judicial independence', see Opinion of AG Tanchev in Case C-619/18 *European Commission v Republic of Poland* EU:C:2019:325 para 58. See also Barcik (n 12) 169.

[33] It should be pointed out that Article 7 TEU plays a somewhat different role, as according to the Court: 'Article 7 TEU, however, plays a very specific role in the system of remedies provided for by the Treaties, since it exceptionally authorises the EU institutions to monitor compliance by the Member States with the fundamental values of the European Union in areas which fall within the exclusive competence of the Member States' – Case C-157/21 *Republic of Poland v European Parliament and Council of the European Union* EU:C:2022:98 para 96.

[34] See Barcik (n 12) 173-176.

[35] ibid 176.

shows how the very operationalisation of common values is most likely the most important development since the Court's judgment in the *Costa* case.[36]

It is also important to emphasize that initiating judicial procedures is not always an easy task, particularly when dealing with those that carry political undertones. The lack of political will to proceed under Article 7 TEU has given rise to a search for other ways to respond to threats to the rule of law in Member States. One such solution is the use of economic tools – the latest mechanism for protecting the rule of law in the EU, combining the protection of the rule of law with budgetary sanctions.[37] This, in turn, is possible due to the regulation protecting the EU budget in the event of generalized deficiencies in the rule of law in Member States. However, Poland[38] and Hungary[39] appealed to the CJEU against this mechanism.

5 OPERATIONALISATION OF THE RULE OF LAW

Article 2 TEU not only contains the values on which the EU is based, including the rule of law, but also underlines the importance of upholding these values both within the EU as a whole and within its Member States. Operationalizing the rule of law involves translating this abstract concept into principles and rules as well as practical measures, which can be used to assess compliance with the rule of law in a given legal system, either EU or national. It is important to add that compliance with this value is also indispensable for ensuring the EU's legitimacy, effectiveness, and protection of fundamental rights.

The *Associação Sindical* case is another landmark ruling towards legal integration in Europe, which is why it is often referred to as constitutional or even revolutionary. It is also seen as a fundamental (or a crucial) moment enabling effective monitoring of judicial independence in the EU.[40] It operationalizes Article 2 TEU, while at the same time interpreting it in connection with other treaty provisions. Consequently, Article 2 TEU becomes an effective tool for protecting the rights of individuals, which can now be effectively applied in proceedings before national and EU courts. Thus, the rule of law, which until now has been protected by the political, burdensome, ineffective, and, above all else, centralised mechanism provided for in Article 7 TEU acquires new opportunities for enforcement. These opportunities are decentralized as they can be applied by any national judge (functionally a European judge) when deciding on individual cases.[41]

As for the facts, in 2014 the Portuguese legislature temporarily reduced the remuneration of employees working in the Portuguese public administration, including judges. The Associação Sindical dos Juízes Portugueses (hereinafter: ASJP) acting on behalf of members of the Tribunal de Contas (Court of Auditors) decided to challenge these salary-cutting measures on the grounds that they infringed the principle of judicial independence enshrined in both the Portuguese Constitution and in EU law (according to Article 19(1)

[36] Marton Varju, *Member State Interests and European Union Law. Revisiting the Foundations of Member State Obligations* (Routledge 2020) 71-72.
[37] See Conditionality Regulation (n 6).
[38] Case C-157/21 *Republic of Poland v European Parliament and Council of the European Union* EU:C:2022:98.
[39] Case C-156/21 *Hungary v European Parliament and Council of the European Union* EU:C:2022:97.
[40] Stoyan Panov, 'Walking the line in times of crisis: EU fundamental rights, the foundational value of the rule of law and judicial response to the rule of law backsliding' (2023) 6(1) Nordic Journal of European Law 60, 67.
[41] See Barcik (n 12) 112.

TEU 'Member States shall provide remedies sufficient to ensure effective legal protection in the fields covered by Union law') as well as in the Charter (Article 47 CFR 'Right to an effective remedy and to a fair trial'). The Portuguese Supreme Administrative Court referred the disputed issue to the CJEU and requested a preliminary ruling. Before concluding that the 'salary-reduction measures at issue in the main proceedings cannot be considered to impair the independence of the members of the Tribunal de Contas',[42] the Court referred to several criteria, which should be adopted by national courts when reviewing measures that may infringe judicial independence.

This case stands out for two reasons. Firstly, by adopting Article 19(1) TEU as an independent legal basis for settling the issue and by applying a broad interpretation of the provisions of the article in question, the Court has broadened the scope of legal protection. However, to apply Article 19(1) TEU, the Court had to find a connecting element/link ('in the fields covered by Union law'), which is where the second element comes into play. The Court applied a systemic interpretation while referring to the EU legal order and the EU itself. It also referred to the catalogue of values enshrined in Article 2 TEU, including the rule of law. Above all, however, it found that the principle of effective judicial protection of the rights individuals derive from EU law (referred to in Article 19(1) TEU) constitutes a general principle of law stemming from the common constitutional traditions of Member States, a fact which is also expressed in Articles 6 and 13 ECHR, and therefore it would apply even in the absence of any positive regulation in primary law.[43]

To justify its decision, the Court referred to three provisions, namely to Article 19(1) TEU (an independent legal basis/ground for settling the issue) in conjunction with Article 2 TEU (the rule of law as an EU value) and Article 4(3) TEU (the principle of sincere cooperation).

The Court began its reasoning by referring to Article 2 TEU. It recalled that the EU is founded on values, including the rule of law, which are common to Member States in conditions where justice prevails and since

> The European Union is a union based on the rule of law in which individual parties have the right to challenge before the courts the legality of any decision or other national measure relating to the application to them of an EU act.[44]
> Article 19 TEU, which gives concrete expression to the value of the rule of law stated in Article 2 TEU, entrusts the responsibility for ensuring judicial review in the EU legal order not only to the Court of Justice but also to national courts and tribunals.[45]

Adding that

> The Member States are therefore obliged, by reason, inter alia, of the principle of sincere cooperation, set out in the first subparagraph of Article 4(3) TEU, to ensure, in their respective territories, the application of and respect for EU law. In that regard, as provided for by the second subparagraph of Article 19(1) TEU, Member

[42] *Associação Sindical dos Juízes Portugueses* (n 8) para 51.
[43] ibid para 35, see also Barcik (n 12) 112-113.
[44] *Associação Sindical dos Juízes Portugueses* (n 8) para 31.
[45] ibid para 32.

> States are to provide remedies sufficient to ensure effective judicial protection for individual parties in the fields covered by EU law.[46]

Thus, the Court found a link between compliance with the rule of law and the principle of effective judicial protection, as one cannot exist without the other,[47] and hence

> to the extent that the Tribunal de Contas (Court of Auditors) may rule, as a 'court or tribunal' […] on questions concerning the application or interpretation of EU law […] the Member State concerned must ensure that that court meets the requirements essential to effective judicial protection, in accordance with the second subparagraph of Article 19(1) TEU.[48]

What stands out in the Court's reasoning is the fact that it relied almost exclusively on Article 19(1) TEU, which, in the Court's words gives 'concrete expression to the value of the rule of law stated in Article 2 TEU', rather than on Article 47 of the Charter. The recourse to Article 2 TEU, which justifies the extension of the operational scope of EU law, as well as to Article 19 TEU, which gives concrete expression to the value in question, has a dual effect, namely, that Article 19(1) TEU operationalizes the rule of law as a value, while the interpretation of Article 19(1) TEU in light of Article 2 TEU justifies its extensive reading.[49] What is more, the Court has chosen to operationalize Article 2 TEU by means of other treaty provisions rather than using Article 2 TEU as a freestanding standard. *Ipso facto* the Court set a new standard, which gives judicial authorities, national and European, the possibility to challenge national measures violating EU law, including judicial independence, in cases where the link with EU law is very weak, or even almost non-existent. The mere fact of being a court with the competence to potentially decide on the interpretation or application of EU law is sufficient to fall within the material scope of Article 19 TEU. Is it not a prime example of integration through law, or rather, integration through the rule of law? Or, to put it yet another way, are we not dealing here with further centralisation, federalisation, and constitutionalisation of the EU through the Court's operationalisation of Article 2 TEU, i.e. by way of judicial activism? Or is this perhaps the natural course of things, a mere functional spillover of integration processes?

Moreover, with the TL which confirmed the principle of conferral and made a clear assignment of competencies, it seemed that judicial activism would be consigned to history. However, the Charter could also provide the grounds for judicial activism but as is well known, its application is limited. It was in the case of *Associação Sindical* that the Court found new opportunities for developing its judicial activism. The Court proceeded with an interpretation of Article 2 TEU in connection with Article 19(1) TEU and Article 4(3) TEU, which justified the protection of judicial independence – a precedent, which can be used in

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[46] *Associação Sindical dos Juízes Portugueses* (n 8) para 34.

[47] Koen Lenaerts, 'On Judicial Independence and the Quest for National, Supranational and Transnational Justice' in Gunnar Selvik et al (eds), *The Art of Judicial Reasoning. Festschrift in Honour of Carl Baudenbacher* (Springer 2019) 162.

[48] *Associação Sindical dos Juízes Portugueses* (n 8) para 40.

[49] Armin von Bogdandy and Luke Dimitrios Spieker, 'Transformative Constitutionalism in Luxembourg: How the Court Can Support Democratic Transitions' (2023) 29(2) Columbia Journal of European Law 71.

the future to link the value enshrined in Article 2 TEU to some other treaty provision[50] which has not, until now, been regarded as an independent legal basis. In this way, the Court opened up new possibilities for its adjudication.[51] What is more, the judgment itself can be read in terms of further federalisation of the EU[52] – an issue that some may find even more appealing. This is all the more so as some argue that the Court has made the principle of effective judicial protection, including judicial independence, a quasi-federal standard of review, which can be invoked before national courts in virtually any situation where national measures target national judges authorised to hear cases based on EU law.[53]

6 ACTUAL AND FUTURE IMPLICATIONS

The case of *Associação Sindical* served as a catalyst, or to put it another way, a major factor leading to the development of an instrument protecting judicial independence which is, at the same time, a general principle of EU law. Portuguese judges, who embody both individual rights and the independence of the judiciary, were given an opportunity to challenge politically (or rather economically) motivated reductions in their salaries. In this way, an institutional barrier was created to protect the independence of the judiciary from attempts to subordinate it politically to the executive or the legislature. In its judgment, the Court also stated that the protection of judicial independence is not an exclusive domain of national regulations and states cannot, just as they wish, regulate the status of judges and the judiciary. They are constrained by the principle of judicial independence which, as a general principle of law, is also a constitutional value of the EU.[54] The judgment itself became a catalyst for efforts to protect the rule of law by means of direct action (a complaint) under Articles 258 and 259 TFEU and resulted in national courts raising further questions regarding the independence of the courts and the judiciary under Article 267 TFEU, i.e. within the framework of preliminary ruling proceedings.

When it comes to integration processes in Europe, two opposing tendencies have been present from the very beginning. At one end of the spectrum has been the tendency towards ever-deeper integration, an ever-closer union of states and peoples, while at the other end there has been the aspiration towards, at best, closer cooperation. The former tendency has been more legal in character albeit also with some political undertones, while the latter is more economically inclined. And since not everything could be written into the treaties, it was the Court, which has been assigned the role of interpreter of EU law, including the provisions of the treaties. In this way, the Court has made a significant contribution to deepening and strengthening inter-state ties at every possible level and in every possible dimension. This, in turn, has sparked opposition from some Member States, including from

[50] For example, Article 10 TEU, for the Court has recently alluded to Article 10 TEU in the context of operationalising democracy as a value enshrined in Article 2 TEU, see e.g.: Case C-502/19 *Criminal proceedings against Oriol Junqueras Vies* EU:C:2019:1115 para 63 where we read: 'Article 10(1) TEU provides that the functioning of the Union is to be founded on the principle of representative democracy, which gives concrete form to the value of democracy referred to in Article 2 TEU'; and Case C-207/21 P *European Commission v Republic of Poland* EU:C:2022:560 para 81, where we find a similar statement.

[51] See Barcik (n 12) 114-115.

[52] ibid 115 and also Danuta Kabat-Rudnicka, *Zasada federalna a integracja ponadnarodowa. Unia Europejska między federalizmem dualistycznym a kooperatywnym* (Lettra-Graphic 2010).

[53] Pech (n 3) 1847.

[54] See Barcik (n 12) 115.

their constitutional courts, which are resisting any extension of the operational scope of EU law – the aggrandizement of EU competences, or to put it another way, to any widening of the operational reach of EU law, which encroaches upon areas reserved for states.

The judgment in the *Associação Sindical* case is also revolutionary in the sense that it operationalizes the provisions of the treaty, which until now have been considered too vague and too general. One could even say that these have functioned as programmatic norms and as guiding principles for EU actions. And for these reasons alone, i.e. the combined reading of Article 2 TEU (the rule of law as a value) and Article 4(3) TEU (the principle of sincere cooperation) and Article 19(1) TEU (the principle of effective judicial protection), along with the requirement that there be a merely hypothetical link between national measures and EU law to bring a case based on Article 19(1) TEU alone,[55] the Court's reasoning is not only innovative but the judgment itself is the most important ruling since *Les Verts*.[56] It is also the first, albeit indirect, response to backsliding in the rule of law observed in some Member States.[57] Indeed, some see this judgment as a response to cases of non-compliance with EU law in Member States other than Portugal. Firstly, in the case at hand, it was not clear how the Court would ultimately decide (at least with regard to the Commission questioning the jurisdiction of the Court) and secondly, later that year, the Commission brought a case against Poland under Article 258 TFEU.

7 CONCLUDING REMARKS

As has been said, by far the most effective instruments for enforcing adherence to the rule of law are those that are judicial in character. Among them is the infringement procedure provided for under Article 258 TFEU, which can be launched by the Commission, or under Article 259 TFEU by a Member State, exclusively in situations where a breach of the rule of law is also a breach of a specific provision of EU law. However, the Court's ruling in the *Associação Sindical* case brought a change in this approach, as the so-called EU link does not have to be a specific provision of substantive law. However, when it comes to situations falling outside the scope of EU law which *ipso facto* cannot be considered a breach of obligations under the treaties, but which still pose a systemic threat to the rule of law, Article 7 TEU applies.

The political mechanism for counteracting violations of the rule of law referred to in Article 7 TEU has proved ineffective, which is why judicial instruments are also used – with reference to preliminary ruling and non-compliance proceedings. Moreover, one economic instrument, the 'conditionality' mechanism, has been put in place, which allows EU funds to be suspended if breaches of the rule of law in a Member State affect the sound management of EU finances or the Union's financial interests. However, the judicial mechanism seems to be by far the most effective, although economic means also play a role. The political mechanism does not work, however, since it depends on the goodwill and cooperation of Member States.

Lastly, it needs to be added that the Court also interprets and applies EU law in areas where the Member States have retained their competences. Hence, Member States must

[55] Pech (n 3) 1829.
[56] ibid 1827.
[57] ibid 1828 and also Bonelli and Claes (n 2) 628.

abide by EU law, even when they apply the laws that fall within areas reserved only for them. States must therefore respect the rule of law, which has been elevated to the rank of a value, i.e. the leading axiological category underpinning the Union – an element of European constitutional identity.

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CHALLENGES OF THE USE OF VIRTUAL ASSETS IN MONEY LAUNDERING

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Cryptocurrencies have vast potential, but they also present significant risks related to money laundering and terrorist financing due to their technical characteristics. Crypto-assets are essentially applications of blockchain technology, which entails a public, encrypted, and secure ledger distributed across a network of validated computers. Each computer operates with common software that fosters consensus on new entries and prevents unauthorized alterations to the agreed-upon register. The Financial Action Task Force (FATF) has issued numerous guidelines on virtual assets, and in September 2020, the European Commission embraced the Digital Finance Package to bring the EU in line with the digital age. A pivotal component of this package is Regulation (EU) 2023/1114 of the European Parliament and of the Council, dated May 31, 2023, on markets in crypto-assets, known as MiCA Regulation. This regulation signifies the EU's endeavor to standardize the legal framework for crypto assets while actively contributing to the prevention of money laundering and terrorist financing. The challenge for regulatory authorities lies in the seizure, confiscation, and forfeiture of crypto-assets as proceeds of crime, given their inherent characteristics that impede traceability. Court decisions outlined in this article underscore the difficulties faced by law enforcement authorities when handling crypto-assets as proceeds of crime. The article examines how European legal authorities and the FATF utilize various legal tools, such as Directives, Regulations, and Guidelines, to adapt to the evolving landscape of virtual assets. To mitigate the risk of forum shopping, where individuals seek the most favorable legal regime, alignment of the legal frameworks of Member States is crucial. The ongoing evolution of the legal framework reflects the persistent challenges posed by virtual assets in the context of criminal activities, prompting a continuous adaptation of regulations by European legal authorities and the FATF.

1 THE DEVELOPMENT AND PROLIFERATION OF VIRTUAL ASSETS

Crypto-assets or virtual assets constitute only a small part of the international financial system, including payment schemes, but they have unlimited potential for further development. Virtual assets represent more than just the digitization of money; they are a way to rebuild trust,[1] a pioneering response to the erosion of trust in the banking system that

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[1] Laura Shin, 'Why Wall Street Journal Currency Report Didn't Understand Money Until He Learned About Bitcoin' (*Forbes*, 20 September 2016) <https://www.forbes.com/sites/laurashin/2016/09/20/why-a-wall-street-journal-currency-reporter-didnt-understand-money-until-he-learned-about-bitcoin/?sh=30f63c744c4e> accessed 10 December 2023; Paul Vigna and Michael J Casey, *Cryptocurrency – how bitcoin and Digital Money are Challenging the Global Economic Order* (St. Martin's Publishing Group 2015) 38.

unfolded since the onset of the economic crisis in 2007.[2] Decentralized crypto-assets, such as Bitcoin and similar virtual assets, are gaining ground globally in the financial world as they represent the most innovative form of payment. In recent years, they have often been associated with criminal activities.[3] The fact that crypto-assets facilitate criminal activities is not new and is widely known.[4] It is observed that criminals use them to anonymize and transfer ill-gotten assets in an untraceable manner. It is noteworthy that nearly half of all Bitcoin transactions can be linked to illegal activities, according to Australian researchers who used specific algorithms to analyze transaction information. Justifiably, there is concern about the growing use of cryptocurrency assets in relation to financial crime.

Crypto-assets undoubtedly are gateways for money laundering and terrorist financing, which criminals can easily exploit. The fact that they are entirely digitalized assets, easily transferable, with no requirement for true identification information – thus with a certain level of anonymity – and the ability to operate on a decentralized basis, makes them particularly conducive to money laundering and other criminal activities.[5]

Virtual assets pose a significant challenge for both national and international legislators, as it has become evident in the approximately fifteen-year history of Bitcoin. Their technical characteristics and peculiarities make it difficult to address them in traditional regulations. However, the most intricate issue is regulating virtual assets within the framework of combating money laundering and terrorist financing and effectively confiscating them in cases where they are products of crime.[6]

Due to the technical nature of digital currencies, the terminology used might be confusing. To clarify, while digital currencies constitute a broad phenomenon, terminology often associates cryptocurrencies with Bitcoin, which is simply the most well-known example.[7] Reference is often made to Bitcoin, and most conclusions related to this currency will be similar or identical to other cryptocurrencies and crypto-assets. Article 3(1) para 5 of the MiCA Regulation[8] defines crypto-assets as a digital representation of value or rights which may be transferred and stored electronically, using distributed ledger technology or similar technology.

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[2] James Crotty, 'Structural causes of the global financial crisis: A critical assessment of the new "financial architecture"' (2009) 33(4) Cambridge Journal of Economics 563, 565.

[3] Jacek Czarnecki, 'Digital Currencies and the Anti-money Laundering/Counter- terrorism Financing Regulations in the EU: Imaginary Risk or Real Challenge?' in Katalin Ligeti and Michele Simonato (eds), *Chasing Criminal Money, Challenges and perspectives on asset recovery in the EU* (Hart Publishing 2017) 287.

[4] Fabian Maximilian Johannes Teichmann and Marie-Christin Falker, *Cryptocurrencies and financial crime: solutions from Lichtenstein* (2021) 24(4) Journal of Money Laundering Control 775.

[5] Robby Houben and Alexander Snyers, 'Crypto-assets: Key Developments, Regulatory Concerns and Responses' (2020) Study Requested by ECON committee, 10 <https://www.europarl.europa.eu/RegData/etudes/STUD/2020/648779/IPOL_STU(2020)648779_EN.pdf> accessed 10 December 2023.

[6] Czarnecki (n 3) 287.

[7] European Central Bank, 'Virtual Currency Schemes' (2012) <www.ecb.europa.eu/pub/pdf/other/virtualcurrencyschemes201210en.pdf> accessed 10 December 2023; European Central Bank, 'Virtual Currency Schemes- A Further Analysis' (2015) <www.ecb.europa.eu/pub/pdf/other/virtualcurrencyschemesen.pdf> accessed 10 December 2023; Financial Action Task Force (FATF), 'Virtual Currencies: Key Definitions and Potential AML/CFT Risks' (2014) FATF Report <https://www.fatf-gafi.org/media/fatf/documents/reports/Virtual-currency-key-definitions-and-potential-aml-cft-risks.pdf> accessed 10 December 2023.

[8] Regulation (EU) 2023/1114 of the European Parliament and of the Council of 31 May 2023 on markets in crypto-assets, and amending Regulations (EU) No 1093/2010 and (EU) No 1095/2010 and Directives 2013/36/EU and (EU) 2019/1937 [2023] OJ L150/40 (MiCA Regulation).

It is practically impossible to provide a comprehensive description of the technological and economic aspects of crypto-assets or the technology on which they are built and therefore will not be the aim of this article. However, some peculiarities of Bitcoin, and crypto-assets in general, are important to mention within the context of applying legislation to combat money laundering in various activities related to cryptocurrencies. Moreover, to understand how the confiscation of crypto-assets as proceeds of criminal activities can be made possible, the characteristics of this type of currency should first be described.

Crypto-assets are built on a technology called 'blockchain'.[9] At its most fundamental level, blockchain is a public, distributed ledger that cannot be altered. The ledger is not stored by a central entity but is distributed among multiple nodes in the network, making it decentralized. The innovation behind blockchain technology (often referred to more broadly as 'distributed ledger technology' or 'DLT') is that it allows identical forms of the ledger to be maintained by nodes, even though each node is unable to impose its own form on others. This is achieved through the use of cryptographic solutions, which assist in reaching consensus among the nodes about which form of the ledger is valid.

In the case of Bitcoin, which represents the first, and so far the most successful, application of this technology, the issuance of currency is allowed without a central issuer, and, as a result, it is not subject to involvement and manipulation by governments.[10] Transactions within a network without intermediaries, such as banks, are also possible. The operations of the blockchain exist as a record of all transactions that have occurred on the blockchain network and are maintained by a series of nodes distributed worldwide. One peculiarity of blockchain technology is that no single entity is solely responsible for the maintenance and control of the blockchain network.

2 CRYPTO-ASSETS AND THE DEVELOPMENT OF BLOCKCHAIN TECHNOLOGY

It is important to emphasize that crypto-assets do not constitute a separate capital of financial innovation but have created significant opportunities in this sector. Bitcoins were simply the first application of blockchain technology. A blockchain technology is a public, encrypted, and secure ledger distributed across a network of validated computers, each of which operates with common software that leads to consensus on new entries and prevents unilateral reentries into the agreed-upon register.[11] Blockchain technology allows for the creation of different asset elements (cryptographic assets) that represent value, existing without any central intermediary. For example, units in a blockchain may be treated not as currency but as shares in a company or other types of rights. Furthermore, the use of smart contracts, i.e. immutable and self-executing contracts executed in a specific blockchain, in certain blockchains, such as Ethereum, enables the creation of complex collaborative structures which operate without central administration.

[9] Certainly, a distinction should be made between the reference to 'blockchain' and 'Blockchain', as the latter specifically refers to the database used in Bitcoin, while the former is a more general term that encompasses the technology itself.
[10] Andrew Haynes and Peter Yeoh, *Cryptocurrencies and Cryptoassets: Regulatory and Legal Issues* (Routledge 2020) 7.
[11] Vigna and Casey (n 1) 64.

There are two main consequences arising from the above, with a focus on regulatory strategies to combat money laundering and terrorist financing. First and foremost, legislators and regulatory authorities should be aware that currency is just one out of many possible applications of blockchain technology. Next-generation applications already include other forms of value. These are based on similar technology but may have different social applications and economic significance. Secondly, new developments, such as decentralized autonomous organizations, introduce an entirely new level of complexity. Cryptocurrencies may require an immediate regulatory response, but regulatory authorities should not overlook further blockchain technologies.[12]

3 THE USE OF CRYPTO-ASSETS FOR MONEY LAUNDERING AND TERRORISM FINANCING

The use of crypto-assets as tools for money laundering and terrorism financing has garnered the interest of many public authorities and organizations, including Interpol and Europol. The latter has described crypto-assets as one of the key drivers changing the way serious and organized crime operates: 'Virtual currencies gradually enable individuals to act as free criminal entrepreneurs conducting crime as a service business model, without the need for advanced criminal infrastructure for money receipt and laundering'.[13] Crypto-assets have been characterized as the ideal tool for money laundering. The assertion that digital currencies enhance the risk of terrorism financing was also supported in the FATF's relevant report titled 'Emerging Terrorist Financing Risks' issued in 2015.[14] Furthermore, Europol stated in the '2015 Internet Organized Crime Threat Assessment' that 'Bitcoin is establishing itself as the single currency for criminals operating in the cybercrime space within the EU' and proposes 'harmonized legislative changes at the European level or the unified application of existing legal tools, such as regulations for combating money laundering, to address the criminal use of virtual currencies'.[15] Interpol even created its own cryptocurrency to learn more about how criminal activities involving digital currencies can be fought. Interpol and Europol have also established a partnership 'against the abuse of virtual currencies for criminal transactions and money laundering', which includes 'policy actions, strengthening cooperation and development programs, and delivering training to combat the criminal use of virtual currencies, allowing for the detection, confiscation, and forfeiture of criminal assets'.[16]

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[12] Czarnecki (n 3) 291.

[13] European Police Office (Europol), 'Exploring Tomorrow's Organized Crime' (2015), 9, 30 <https://www.europol.europa.eu/cms/sites/default/files/documents/Europol_OrgCrimeReport_web-final.pdf> accessed 10 December 2023.

[14] FATF, 'Emerging Terrorist Financing Risks' (2015) FATF Report, 24 <https://www.fatf-gafi.org/media/fatf/documents/reports/Emerging-Terrorist-Financing-Risks.pdf> accessed 10 December 2023.

[15] Interpol, 'Darknet Training Shines Light on Underground Criminal Activities' (*Interpol*, 31 July 2015)<https://www.interpol.int/News-and-Events/News/2015/INTERPOL-Darknet-training-shines-light-on-underground-criminal-activities> accessed 10 December 2023.

[16] Europol, 'Europol - Interpol Cybercrime Conference Makes the Case for Greater Multisector Cooperation' (*Europol*, 2 October 2015) <https://www.europol.europa.eu/media-press/newsroom/news/europol-%E2%80%93-interpol-cybercrime-conference-makes-case-for-greater-multisector-cooperation> accessed 10 December 2023.

There is a need for continuous, evidence-based, and in-depth empirical analysis of the use of virtual assets for illegal activities. It is not unlikely that new evidence or arguments regarding the use of virtual assets for money laundering and terrorism financing triggered and expedited regulatory proposals in the EU concerning the combat against money laundering and terrorism financing.[17]

The constantly emerging challenges in the field of crypto-assets regarding money laundering have led to the publication by the FATF in June 2022 of the 'Targeted Update on Implementation of the FATF Standards on Virtual Assets/VASPs'.[18] Only a year later on June 2023, FATF published another update regarding virtual assets under the title: 'Virtual Assets: Targeted Update on Implementation of the FATF Standards on Virtual Assets and Virtual Asset Service Providers'.[19] The last report is an update on country compliance with FATF's Recommendation 15 and its Interpretative Note (R.15/INR.15), including the Travel Rule, and updates on emerging risks and market developments, including on Decentralized Finance (DeFi), Peer-to-Peer transactions (P2P), and Non-Fungible Tokens (NFTs), unhosted wallets, and stablecoins.

The European Commission adopted the Digital Finance Package in September 2020, in order to respond to the challenges of the digital age. The package includes the digital finance strategy, retail payments strategy, crypto-asset legislative proposals, and digital operational resilience legislative proposals. Regulation (EU) 2023/1114 of the European Parliament and of the Council of 31 May 2023 on markets in crypto-assets, and amending Regulations (EU) No 1093/2010 and (EU) No 1095/2010 and Directives 2013/36/EU and (EU) 2019/1937, which is also known as MiCA Regulation, is based on Article 114 TFEU, which lays the legal groundwork for establishing an internal market. The EU is empowered to enact legislation harmonizing any national laws that might hinder the free movement of goods, services, capital, or people, thereby addressing obstacles to the internal market. The MiCA Regulation has been proposed following the subsidiarity principle, which allows the Union to intervene and take action when the objectives of an action cannot be adequately achieved by the Member States on their own.

The EBA and ESMA have previously emphasized that, despite existing EU legislation specifically addressing money laundering and terrorism financing, a majority of crypto-assets remain beyond the purview of EU financial services regulations. Consequently, they escape provisions related to consumer and investor protection, market integrity, and similar aspects, despite carrying associated risks.

In light of this, the MiCA Regulation aims to actively contribute to the prevention of money laundering and terrorism financing. In this context, it is imperative that the definition of 'crypto-assets' aligns with the one outlined for 'virtual assets' in the recommendations of the FATF. Moreover, any catalog of crypto-asset services should encompass virtual asset

[17] Czarnecki (n 3) 291.

[18] FATF, 'Targeted Update on Implementation of FATF Standards on Virtual Assets and Virtual Asset Service Providers' (2022) <https://www.fatf-gafi.org/content/dam/fatf-gafi/guidance/Targeted-Update-Implementation-FATF%20Standards-Virtual%20Assets-VASPs.pdf.coredownload.pdf> accessed 10 December 2023.

[19] FATF, 'Targeted Update on Implementation of the FATF Standards on Virtual Assets and Virtual Asset Service Providers' (2023) <https://www.fatf-gafi.org/content/dam/fatf-gafi/guidance/June2023-Targeted-Update-VA-VASP.pdf.coredownload.inline.pdf> accessed 10 December 2023.

services that are likely to raise concerns related to money laundering, as identified by the FATF.[20]

4 CONFISCATION OF CRYPTOCURRENCIES

The unique nature of crypto-assets poses many challenges regarding the effective detection, investigation, and confiscation of proceeds of crime related to them.[21] Specifically, the inadequate knowledge about virtual assets, their characteristics, and the techniques that could be used to combat crypto-assets related with criminal activities make their detection more difficult. Their digital nature mainly entails electronic evidence of the crimes committed, encumbering the addressing of crimes involving them. Furthermore, there is often a lack of legislative and regulatory responses specifically aimed at recovering proceeds of crime acquired through or with the assistance of virtual assets. Additionally, difficulties in monitoring and coordinating actions taken, both at national and international levels, have been identified.[22]

To consider the conversion of assets into crypto-assets or vice versa as a criminal offense, it must first be assessed whether and to what extent crypto-assets can be considered assets, assigning them the appropriate legal classification.[23] Depending on such classification, it can then be determined how and whether the confiscation of these crypto-assets is possible. According to case C-264/14[24] and in accordance with the 2012 report of the European Central Bank, virtual currencies were defined as electronically transmitted money, not subject to regulation. The issuance and control of these funds by their issuers are accepted by their members. Some similarities exist between these virtual currencies and other exchangeable currencies in terms of their use. However, there are significant differences, as they cannot be expressed in any conventional unit, such as euros or dollars, but in a virtual unit (for example bitcoin). Therefore, the Court's judgment was that bitcoin constitutes a conventional means of payment and could therefore be characterized as an intangible asset.[25] Directive 2018/843/EU defines virtual assets as digital representations of value that are not issued by a central bank or public authority. They do not have their guarantee, are not necessarily linked to legally circulating currencies, and do not have the legal status of currency or money, but are accepted by natural or legal persons as a means of exchange and can be transferred, stored, or electronically traded.[26]

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[20] Commission, 'Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on Markets in Crypto-assets, and amending Directive (EU) 2019/1937' COM (2020) 593 final, 4.

[21] United Nations Office on Drugs and Crime (UNODC), 'Basic Manual on the Detection and Investigation of the Laundering of Crime Proceeds Using Virtual Currencies' (2014) <https://www.imolin.org/pdf/imolin/FULL10-UNODCVirtualCurrencies_final.pdf> accessed 10 December 2023.

[22] Czarnecki (n 3) 291.

[23] George Papadimitrakis, 'Legitimization of Income from Criminal Organization and Cryptocurrencies' (2018) 9 Armenopoulos 1598.

[24] Case C-264/14 *Skatteverket v David Hedqvist* EU:C:2015:718.

[25] For the current regulations in the USA, see Christos Mylonopoulos, 'Is issuance possible in the USA for legitimizing cryptocurrencies derived from criminal activity' (2018) Criminal Chronicles 185; Texas District Court's decision, SEC v Shavers, 2013 Fed. Sec. L. Rep, CCH) P 97, 596 (E.D. Tex Aug 6, 2013) Jeffrey E. Alberts & Bertrand Fry Is B A Security/ BITCOIN J. Sci. & Tech.

[26] Directive (EU) 2018/843 of the European Parliament and of the Council of 30 May 2018 amending Directive (EU) 2015/849 on the prevention of the use of the financial system for the purposes of money laundering or

Confiscation, forfeiture or seizure of the proceeds or instruments of crime are complex processes, both substantively and procedurally. Naturally, their application to virtual assets is even more complex due to their particular characteristics (anonymity, difficulty of traceability, possibility of cross-border transactions).[27] Transactions involving crypto-assets are not recorded. They are anonymous, international, and irreversible. When traditional legal tools of criminal prosecution and enforcement are applied in cases involving decentralized virtual currencies, challenges arise. For example, there might not be a contracting party, such as a central administrator, who can identify and apply attachment and confiscation decisions to assets held in the form of crypto-assets. Under these circumstances, it becomes difficult for regulatory authorities to take enforcement actions involving the seizure, forfeiture, and confiscation of illegal assets. FATF guidelines provide some guidance on clarifying responses to money laundering risks arising from crypto-assets, but each national jurisdiction has adopted a different approach to regulating on the matter.[28]

The provided anonymity impedes determining the individuals involved. The protocols on which almost all decentralized crypto-assets are based do not require identification and verification of participants. Moreover, the transaction history records created on the blockchain from the basic protocols are not necessarily linked to the real-world identity of the person. This level of anonymity restricts the usefulness of the blockchain for monitoring transactions and detecting suspicious activity. It poses a significant challenge for law enforcement authorities to trace illegally obtained income that may be laundered using cryptocurrencies, let alone confiscate them. Additionally, these authorities cannot target a central location or entity for investigative purposes.[29]

Furthermore, there is an additional risk of not being able to locate the legal entity responsible because virtual currencies do not require the involvement of a third party, with the possible exception of exchanges. Consequently, criminal prosecution cannot be pursued, and therefore, the confiscation of the proceeds of crime cannot be imposed. Senders and recipients can conduct transactions with cryptocurrencies directly, without requiring identification, as there are no names attached to wallet addresses, and there is no mediation that could involve informing authorities of suspicious transactions. Crypto-assets as payment methods are not limited and are accepted without jurisdictional boundaries. Crypto-assets transactions require nothing more than internet access, and their infrastructure is often distributed worldwide hindering tracing irreversible transactions. In addition, crypto-assets operate and evolve online, blurring national borders and elevating e-commerce to an international phenomenon. In light of these facts, one of the most challenging aspects of recovering the proceeds of crime in cases related to virtual assets is the applicable jurisdiction and the requirements for international cooperation.[30]

Beyond the above, another factor that discommodes confiscation of crypto-assets is the fact that no interaction with the regulated financial system is required, and transactions

terrorist financing, and amending Directives 2009/138/EC and 2013/36/EU [2018] OJ L156/43 (Directive 2018/843) Art 1(2)(d).

[27] UNODC, 'Basic Manual' (n 21) Module 4: Seizure of Virtual Currencies, 135.

[28] Haynes and Yeoh (n 10) 16.

[29] FATF, 'Guidance for a Risk-based Approach to Virtual Currencies' (2015) 38 <https://www.fatf-gafi.org/content/dam/fatf-gafi/guidance/Guidance-RBA-Virtual-Currencies.pdf.coredownload.pdf> accessed 10 December 2023.

[30] UNODC, 'Basic Manual' (n 21) Module 4: Seizure of Virtual Currencies, 135.

are not monitored. Moreover, piracy in crypto-assets software, wallets, and exchanges, allow criminal organizations to involve other individuals in their illegal activities. It is a fact that criminals tend to use any available means to cover their tracks. There are no adequate safeguards to combat piracy and there is a lack of controls on electronic wallet providers, exchanges, and trading platforms. This allows criminals to steal identities and consequently involve others in their criminal activities. In this way, in some jurisdictions, the seizure of assets and confiscation is avoided.[31] Specifically regarding confiscation, in cases where asset forfeiture procedures are correctly applied, the confiscation of crypto-assets or their equivalent value should not significantly differ from the confiscation of other forms of property.

Recently, the United Nations Office on Drugs and Crime issued the 'Digest of Cyber Organized Crime,[32] resolving some issues arising from the use of crypto-assets in criminal activities, such as jurisdiction, identification, and tracing of illegal assets. However, in practice, the problem remains that the use of cryptocurrencies by criminals makes it nearly impossible to achieve restorative justice for the victims, as the seizure and confiscation of the proceeds of crime is neither easy nor speedy.[33]

Regulatory rules regarding the confiscation of criminal proceeds, both at national and international level, appear inadequate in addressing the challenges associated with crypto-assets. There are no established practices for recovering criminal proceeds at any of the usual stages: detection, seizure, and confiscation of digital currencies. The Directive adopted on the confiscation and recovery of crime proceeds establishes a framework of minimum rules imposed for the detection, tracing, and confiscation of the proceeds of crime throughout the EU[34] and represents a step in the right direction. However, it raises the question of whether national legislation regarding the application of the Directive will be effectively applied in cases involving cryptocurrencies.[35]

It should be noted that there have been few cases involving the seizure and confiscation of virtual assets on an international level. Therefore, much of what is discussed below is based on general principles of establishing jurisdiction over virtual currencies as products/tools of crime.[36] One of the biggest challenges here is the so-called 'cloud computing'. Virtual assets wallets are stored in a 'cloud' infrastructure and are subject to frequent data transfers from one server to another, easily bypassing national borders. In cybercrime investigations facing such challenges, this is often referred to as 'location loss'. However, the principle of territoriality remains the starting point for establishing jurisdiction. Therefore, all means of cooperation should be used to attempt to determine the location of a wallet for as long as the data remains in a specific server within a particular jurisdiction.[37]

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[31] European Banking Authority, 'Opinion on "Virtual Currencies"' EBA/Op/2014/08, 33.
[32] UNODC, 'Digest of Cyber Organized Crime' (2022) 108 <https://sherloc.unodc.org/cld/uploads/pdf/22-10875E_ebook_cb.pdf> accessed 10 December 2023.
[33] European Banking Authority, 'Opinion on "Virtual Currencies"' (n 31) 33.
[34] Directive 2014/42/EU of the European Parliament and of the Council of 3 April 2014 on the freezing and confiscation of instrumentalities and proceeds of crime in the European Union [2014] OJ L127/39.
[35] Czarnecki (n 3) 293.
[36] UNODC, 'Basic Manual' (n 21) Module 4: Seizure of Virtual Currencies, 135.
[37] Jan Spoenle, 'Cloud Computing and cybercrime investigations: Territoriality vs. the power of disposal?' (2010) Discussion Paper prepared for the Economic Crime Division of the Council of Europe, 5 <https://rm.coe.int/CoERMPublicCommonSearchServices/DisplayDCTMContent?documentId=09000016802fa3df> accessed 10 December 2023.

Financial investigations focusing on virtual currencies as products and tools of crime are relatively recent. Therefore, tested approaches addressing issues arising from the use of virtual assets[38] have not yet been developed. The identification of assets and, in general, the tracking of the money's path are crucial parts of financial investigations in order to establish the criminal origin of the products or to determine the means of the crime. The identification of assets, as in any criminal or financial information investigation, relies on certain indicators, known as 'red flags', which can assist and guide the investigator in determining the criminal nature of the assets under scrutiny. This method of identification is useful not only for investigations but also for tracking virtual currency transactions.

As indicators, red flags are considered:

a) A large number of bank accounts maintained by the same administrator of a virtual assets exchange company, sometimes in different countries, used as accounts for continuous money flows (it may be an indicator of layering, which constitutes the second stage of money laundering), without any logical reason for such a structure;
b) The existence of a virtual assets administrator or exchange company based in one country but having accounts in other countries without a significant customer base in the latter, indicating an inexplicable business policy that may be considered suspicious;
c) Capital transfers between bank accounts maintained by different administrators of virtual assets exchange companies domiciled in different countries, which again may constitute an indicator of layering if it does not align with a business model;
d) The intensity and frequency of cash transactions structured in a way that does not exceed the reporting threshold conducted by the owner of a virtual assets' administrator or virtual currency exchange company without any economic sense or purpose;
e) Virtual assets systems lacking proper registration and transparency are popular among criminal groups.

As it is evident from the above, these indicators are directed at the points of contact between crypto-assets and established institutions, currency exchanges, payment services for virtual assets, and hosting services.

In the event that, despite the aforementioned challenges, the confiscation and seizure of crypto-assets as proceeds of crime are achieved, law enforcement agencies face the challenge of managing the seized assets. The ownership of the property remains with the original owner as long as the confiscation decision is pending, and for this reason, the management of the seized assets should be handled with great care. Virtual assets, whether centralized or decentralized, cannot undergo physical deterioration as crypto-assets,[39] although they are subject to significant fluctuations in exchange rates. This may concern law enforcement authorities as the confiscation of assets may be pending. The value of the

[38] UNODC, 'Basic Manual' (n 21) Module 4: Seizure of Virtual Currencies, 135.
[39] David Gilson, 'Bitcoins seized by Drug Enforcement Agency' (*CoinDesk*, 24 June 2013) <http://www.coindesk.com/bitcoins-seized-by-drug-enforcement-agency/> accessed 10 December 2023.

confiscated property at the time of discovery and during the final confiscation might vary significantly. Therefore, a revision of the amount and value of the cryptocurrencies to be seized may be required.[40]

5 JUDICIAL DECISIONS REGARDING CONFISCATION OF CRYPTOCURRENCIES

Given the unique nature of crypto-assets, there have been few judicial decisions ordering confiscation as mentioned above. One of the few decisions addressing this issue is the discussed below decision of the German Federal Court (Bundesgerichtshof – BGH), which could open to a fruitful dialogue on how to address the significant challenges that arise. This study aims to highlight the complexity of judicial control in light of the use of advanced technological methods by criminals, which appear to outpace law enforcement authorities. However, the primary problem that needs to be stressed for further consideration is the significant difficulty in actually removing criminal proceeds or assets when they are virtual assets stored with a private key known only to the owner. There is a significant risk that the perpetrator of the crime is sentenced to a term of imprisonment but still retains an unchanged, if not significantly larger – due to fluctuations in the value of crypto assets – criminal wealth acquired from the crime.

This article aims to shed light on certain of these aspects and highlight issues in the context of the transnational and international confiscation of cryptocurrencies. Specifically, according to the facts described in the decision No. 1 StR 412/16 of July 27, 2017 by the German Federal Court, two perpetrators jointly decided in early 2012 to organize a botnet. The said botnet consists of a union of a large number of computers where programs automatically perform repetitive computational tasks in the background, without the user's knowledge. These programs automatically connect to a central command and control server called a bot herder, allowing remote control of the connected computers, with the aim of benefiting the individuals who control the central server. The botnet designed by the perpetrators was aimed both at Bitcoin mining and data espionage. Victims unknowingly installed bots on their computers through what is known as a 'Trojan horse', a camouflaged malicious software. Additionally, victims' computers were infected through a security vulnerability in their operating system, web browser, or some software.

Bitcoin is a globally available decentralized payment network and a virtual assets unit. Bitcoins are transferred over the internet and processed through a decentralized network of computers, without the involvement of a central authority. The management of these funds is entrusted to individual participants through personal digital wallets. For this purpose, there is a public key that is recognizable to every network participant and a private key known only to the wallet owner. The market value of Bitcoin is determined by supply and demand. Each transaction must be confirmed as valid by the majority of participants in the network to be considered completed. Subsequently, this results in the simultaneous creation of new Bitcoins. The computational operations required to verify transactions involve solving cryptographic tasks that extend the public transaction ledger of the cryptocurrency (blockchain). The algorithms that need to be solved become increasingly complex as the

[40] UNODC, 'Basic Manual' (n 21) Module 4: Seizure of Virtual Currencies, 135.

number of Bitcoins increases. At the same time, the total computational power required to solve them also increases. Each participant who performs the computational task is rewarded with the recently mined Bitcoins in their digital wallet. As the computational power increases, the likelihood of finding the correct result also increases. However, the cost of electricity required by regular processors minimizes the profitability derived from the newly created Bitcoins. To increase their value, the bot herder, who controls the botnet network through the central command and control server, engages in illegal activities. The perpetrator burdens unsuspecting computer users with the cost of electricity consumption during the resolution of computational tasks, which he has already infected with malicious software.

According to the actual circumstances of the decision, one of the two perpetrators created a 'Trojan horse' in the form of music, video, or a program offered for download from the internet. In this way, he gained the ability to mine Bitcoin through the computers of unsuspecting users, burdening them with the cost of electricity consumption. Subsequently, the two perpetrators jointly enriched the malicious software with a concealment wall developed by one of them with the main malicious software program. One of the two defendants then began uploading files infected with malicious software to various Usenet servers. The Trojan horse was intended for operating systems from Windows XP to Windows 7. The firewall serves as access protection for networks and is configured to prevent attacks on the user's computer from the internet. If the malicious software that the user had downloaded did not take the form of music, video, or a program, the program that allowed the central command and control server to access the computer would have undergone this check through the firewall, and access would have been denied.

From early 2012 until the end of the following year, 327,379 users unknowingly 'downloaded' malicious software onto their computers, believing it to be a desired music, video, or program file. When asked if they wanted to install the program, they responded affirmatively, thereby unintentionally installing the Trojan horse on their computers, and disabling their Firewall protection programs in at least 245,534 cases during the execution of this act. This action allowed the perpetrators to gain access to the users' data. The users believed they were downloading harmless files, while in reality, they were unwittingly installing spyware and granting access to their network data. Without this deception of the users, access to the data would have been prevented by the Firewall program, which would have rejected incoming connection requests from the network controlled by the defendants. After 120 seconds of user inactivity, the computing power of the computers' graphics cards was used to perform complex calculations, for which the perpetrators were rewarded with Bitcoin crypto-assets. Furthermore, through another program (Zeus), the registration of user account information, secret numbers, and passwords was transferred to the defendants in an unencrypted format.

According to Article 303a of the German Criminal Code, anyone who unlawfully deletes, copies, renders useless, or alters data is punishable by law. This provision protects the interest of the holder in the integrity of stored or transmitted data. In this regard, it was found that the legal requirements of provision were satisfied as the installation of malicious software changed the settings' content to execute certain functions. Data alteration, as mentioned in the objective substance of Article 303a of the German Criminal Code, is established by impairing the function of the data, resulting in a change in their informational

content.[41] Furthermore, according to Article 303a of the German Criminal Code, anyone who, without authorization, gains access to data not intended for them and protected against unauthorized access is punishable by law. Data are considered protected when the holder has declared interest in maintaining confidentiality by taking security measures.[42] In the present case, the data was highly protected against unauthorized access through the activated Firewall system. Therefore, the defendants, by gaining access to the data, essentially committed the crime described in Article 303a of the German Criminal Code.

There is a plurality of crimes, the value of which can be captured and attributed through the application of multiple criminal provisions.[43] According to the considerations in the discussed decision, the aforementioned actions are committed together in fact. In general, this happens when multiple crimes are committed through a single act.[44] It is generally considered that crimes are committed together when one crime is committed during the commission of a continuous crime and until the completion of this crime.[45] In this case, the actions were committed in a factually consecutive manner according to Article 25 para. 1 of the German Criminal Code since the victims themselves unintentionally installed the Trojan horse on their computers.[46]

According to Article 73 para. 1 of the German Criminal Code, as it stood before the amendment on 1 July 2017, if a punishable act was committed, and the perpetrator or participant has gained anything from it or for it, the court would order its forfeiture. This provision does not apply in cases where the victim has a gain, the satisfaction of which would remove the value of what has been acquired from the act of the perpetrator or the participant. In its current form of the article, it is provided that if the perpetrator or participant has acquired anything from the punishable act or for it, the court orders its seizure.

As it emerges from the above facts of the case, Bitcoin, regardless of their legal nature, were acquired through a criminal act, specifically through the alteration of data under Article 303a of the German Criminal Code. In light of their market value, they constitute a realizable economic value, given that the defendants were the beneficiaries with the right to dispose of them.[47] Therefore, their confiscation was ordered under Article 73(1) para. 1 of the German Criminal Code, in its previous formulation. The argument that Bitcoins cannot be confiscated because they do not constitute an object, or a right, cannot be accepted. Due to their inclusion in a Blockchain network and the combination of the public and the defendant's known private key, they were adequately determined. Consequently, they can be confiscated, even if they are not tangible objects. However, the notion in the decision, that whether the defendant's private key for the digital wallet is known to the investigative

[41] Deutscher Bundestag 10. Wahlperiode (1986) Drucksache 10/5058, 35; Sonja Heine, 'Bitcoins und Botnetze – Strafbarkeit und Vermögensabschöpfung bei illegalem Bitcoin-Mining' (2016) NStZ 441-443.
[42] BGH cases dated at 21st July 2015 – 1 StR 16/15, NStZ 2016, 339, on 6th July 2010 – 4 StR 555/09, NStZ 2011, 154, Graf/Jäger/ Wittig, (2017), Wirtschafts- und Steuerstrafrecht Kommentar, 2nd edition, article 202a, no. 19, C.H. Beck.
[43] Heinz-Bernd Wabnitz and Thomas Janovsky, *Handbuch des Wirtschafts und Steuerstrafrechts* (4th edn, C.H. Beck 2014) 14th chapter, no 108; Thomas Fischer, *Strafgesefzbuch* (64th edn, C.H. Beck 2017) article 303a, no 2; Hagen Wolff et al, *Strafgesetzbuch. Leipziger Kommentar* (12th edn, De Gruyter 2008) article 303a no: 4, 798.
[44] Christos Mylonopoulos, *Criminal Law, General Part* (P.N. Sakkoulas 2008) Chapter II, 324.
[45] Stamati, *Systemic Interpretation of Criminal Law* (P.N. Sakkoulas 2005) Articles 1-133, Article 94 n. 35, 986.
[46] Thomas Frank, in Eric Hilgendorf et al, *Informationsstrafrecht Und Rechtsinformatik* (Logos Berlin 2004) 23.
[47] BGH, case of 12th May 2009 – 4 StR 102/09, NStZ-RR 2009, 320, and of 17th of March 2016 – 1 StR 628/15, BGHR StGB article 73.

authorities does not affect the confiscation provision, is problematic. The decision was based on the fact that knowledge of the key is not a prerequisite for the effective assumption of the power of disposal over the Bitcoins, as it concerns only the execution of the provision and does not affect the provision per se. The court overlooked that the private key was not known at the time of the provision's issuance, and the cooperation of the defendants in its execution was absolutely necessary, without, however, being able to compel them to cooperate.

In this way, the judicial decision persists in a sphere of legal formalism, bypassing the fundamental problem of cases of this nature, namely the confiscation of criminal wealth acquired in Bitcoins, which requires knowledge of the private key of the perpetrators. The retention of criminal wealth sends the message that crime 'pays' and, given that organized criminal groups are significantly affected only when they are deprived of their profits, while they are hardly affected by the imposition of a penalty on a member,[48] the risk of the use of advanced technological means for the commission of crimes looms large.

The analysis of the above decision raises several issues. Firstly, due to the complex structure and operation of such criminal activities, which are carried out exclusively through the use of technology, their investigation proves to be extremely challenging, especially in locating and quantifying criminal proceeds. Furthermore, the primary issue appears to be the existence of a private key that prevents authorities from accessing the digital wallets of the defendants even after confiscation. Therefore, in cases where the defendant does not disclose their private key, it is highly likely that they will retain their criminal gains. Exceptional difficulty also arises in determining the victim's damages, to the extent that the claim for restitution loses substance. Moreover, competent authorities require appropriate training, sufficient staffing, and the necessary resources to effectively combat criminal activities in the digital sphere. The use of crypto-assets for criminal purposes obliges the European legislator to continuously update legislation to align with current realities.

Another case from the Bulgarian court regarding the seizure of crypto-assets worth 3,000,000,000 bitcoins is also discussed. More specifically, Bulgarian law enforcement authorities, in cooperation with the Southeast European Law Enforcement Center, a local organization consisting of 12 Member States based in Bulgaria, conducted a coordinated effort in May 2017 to dismantle an extremely complex criminal organization. In this successful operation, authorities arrested 23 Bulgarian nationals and seized 213,519 bitcoins. The criminal organization's modus operandi involved sophisticated techniques, including piracy within the Bulgarian customs department, to ensure that the associates of the criminal organization did not pay the required duties for importing products into the country. To execute their plan, the criminal organization had installed viruses in electronic systems through corrupt customs officials to allow remote access to hackers. In this way, it appeared that the duties for the cargoes of the criminal organization's associates were paid, while, in reality, the obligation to pay still existed. As a result, for the year 2015 alone, approximately 5,000,000 Euros in damages were incurred by the customs department. During the investigation, law enforcement authorities seized 213,519 bitcoins, valued at 500,000,000

[48]Aristomenis Tzannetis, 'The confiscation of laundered products of criminal activity' in Minutes of the 4th Congress of the Hellenic Criminal Bar Association: Money laundering – 'Clean or Free Society?' [in Greek] (2007) 249.

dollars at the time. With the inflation of the Bitcoin's value from the time of confiscation until December 2017, the seized amount had reached 4,000,000,000 dollars. The criminal organization chose to use Bitcoins due to their capacity of evading authorities' control. The seizure of such a significant amount of crypto-assets could serve the purpose of bolstering the state budget.

It should be noted that there is lack of specialized knowledge among law enforcement authorities regarding the operation of crypto-assets. Therefore, there is a risk of a significant decrease in the value of the seized assets. In the case discussed above, the value of the crypto-assets skyrocketed. Nevertheless, given the lack of stable criteria and data on the extremely large fluctuations in the value of crypto-assets, their conversion into conventional currencies should take place immediately after confiscation. Otherwise, the establishment of a specialized team for managing the seized crypto-assets, either at the national or European level, is deemed necessary. The role of this team would be to identify the optimal point in time for liquidating the crypto-assets to maximize the benefit to the state budget.[49]

The EU should intervene with an effective, unified regulatory framework for the confiscation of cryptocurrencies as proceeds of criminal activities, applicable across all Member States. Taking action at European level and integrating a consistent level of regulation for virtual currencies presents clear advantages. It ensures the identification and assessment of risks for participants in this market across the entire EU. The nature of crypto-assets allows their creation in one Member State and use worldwide. Differing levels of regulation by Member States lead crypto-assets businesses and users to choose the most convenient regulation, which can vary depending on the chosen country.[50]

The increased risks associated with the use of crypto-assets and the need to maintain economic stability require a direct regulatory response. Such a response can be even more effective if coordinated internationally. A heterogeneous mix of national regulations does not adequately address emerging risks and concerns of economic stability. Moreover, participants in the market operate on an international scale. Economic stability is undermined by the increased use of crypto-assets, but it can be assisted through systematic control. Transparency regarding amounts, structure, and purpose of crypto-assets is crucial. For this reason, the Euro zone monitors the amounts transferred and exchanged, as well as transaction prices, as it is connected to the 'traditional' financial sector.[51] These challenges mentioned above undermine countries' ability to enforce effective and persuasive sanctions. Each country must address the challenges within its own framework to identify gaps and take appropriate measures. Licensing and registration of crypto-assets exchanges, customer identification/verification requirements, and record-keeping obligations can facilitate countries in enforcing better and more effective measures. For more effective confiscation of crypto-assets as products of crime, countries need to provide sufficient and effective international cooperation. The goal is to assist in combating money laundering and related predicate offenses. Therefore, mutual discovery, enforcement, seizure, and forfeiture of assets and means of crime in the form of crypto-assets need to be facilitated. Adequate

[49] Usman W Chohan, 'Fiscal Experiences with Bitcoin: Bulgarian Case Study' (2018) Discussion, Paper Series: Notes on the 21st Century, 2.
[50] European Banking Authority, 'Opinion on "Virtual Currencies"' (n 31) 46.
[51] European Central Bank, 'Draghi M. Letter (QZ- 045) to Members of the European Parliament' (2017) ECB Public, Frankfurt, L/MD/17/284.

supervision and regulatory control of convertible crypto-assets operating within each country's jurisdiction would enable countries to provide assistance in investigations. The lack of effective regulation and the ability to conduct investigations in most countries hinder substantial international cooperation. Furthermore, many countries lack a legal framework, which allows the criminalization of certain money laundering and terrorism financing activities using crypto-assets, making it difficult to act effectively in cases of dual criminality.[52]

The complete decentralization of crypto-assets is their greatest adversary, with the potential to lead to their demise or make them experimental projects with limited practical use in the broader economy. Establishing a strong payment system requires the existence of a central authority that provides licensing and assumes responsibility for facilitating payments. This authority, among other things, is responsible for facilitating payments and dealing with any issues arising from the activities it supervises. Therefore, the assistance of such an authority would also facilitate the confiscation of crypto-assets as criminal proceeds. However, the idea of a central authority has faced criticism because it creates a private monopoly without fully addressing the problem of responsibility, which is deeply rooted in decentralized cryptocurrencies.[53]

6 THE 5TH DIRECTIVE 2018/843/EU & THE 6TH DIRECTIVE 2018/1673 ON COMBATING MONEY LAUNDERING CONCERNING CRYPTOCURRENCIES, MICA REGULATION & FATF GUIDANCE

In order to address the challenges posed by crypto-assets, the European legislator included in the scope of the legislative framework, as obligated entities, the 'providers of services for the custody of digital wallets'[54] and the 'providers engaged in the exchange services between virtual currencies and fiat currencies'.[55] Member States undertook the obligation to transpose this directive into their national law by 10 January 2020.[56] As obligated entities, providers of services for the custody of digital wallets and providers engaged in exchange services between virtual assets and fiat currencies are required to comply with the requirements imposed on banks and other financial institutions.[57] They must register with the authorities responsible for combating money laundering, implement due diligence controls, monitor crypto-assets transactions, and report any suspicious activity to government authorities.[58]

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[52] FATF, 'Guidance for a Risk-based Approach to Virtual Currencies' (2015) (n 29) 38.
[53] Asress Adimi Gikay, 'Regulating Decentralized Cryptocurrencies Under Payment Services Law: Lessons from European Union' (2018) 9(1) Law Journal of Law, Technology & the Internet 1, 14.
[54] The definition of 'custodian wallet provider' is attributed to Article 3, paragraph 19 of the 4th Directive on combating money laundering, as amended by Article 1 of the 5th Directive.
[55] Directive 2018/843 (n 26).
[56] ibid Article 4.
[57] European Supervisory Authority, 'Joint Opinion of the European Supervisory Authorities on the risks of money laundering and terrorist financing affecting the European Union's financial sector' (2019) 17, <https://eba.europa.eu/sites/default/documents/files/documents/10180/2622242/1605240c-57b0-49e1-bccf-60916e28b633/Joint%20Opinion%20on%20the%20risks%20on%20ML%20and%20TF%20affecting%20the%20EU%27s%20financial%20sector.pdf?retry=1> accessed 10 December 2023.
[58] Commission, 'Commission Staff Working Document accompanying the document Report from the Commission to the European Parliament and the Council on the assessment of the risk of money laundering

However, after the adoption of the 5th Directive on combating money laundering from criminal activities, there have been changes in the field of crypto-assets. New crypto-assets were created, new types of such services emerged, and new service providers entered this market.[59] In response to these new developments, FATF changed its recommendations in October 2018, which are applicable to financial services involving crypto-assets and similar service providers.[60] In June 2019, FATF issued an interpretative note to Recommendation 15 (INR 15) to further clarify how the requirements should be applied concerning virtual assets and virtual asset service providers. At the same time, new Directives were adopted[61] on applying a risk-based approach to virtual assets and virtual asset service providers. These new Directives focus on points where virtual assets activities intersect with and provide gateways to and from the traditional financial system,[62] such as so-called crypto exchanges. The aim of these new directives is to assist in better understanding the evolution of regulatory and supervisory responses to virtual asset activities by national authorities. Providers of virtual asset services and individuals seeking to engage in digital currency activities should be aware of their obligations related to combating money laundering and should comply effectively.[63]

In the revised form of Recommendation 15, countries are required to control virtual asset service providers for the purposes of combating the laundering of proceeds from criminal activities, license them, and register them.[64] This means that everyone must be subject to an effective system of control and compliance with the measures outlined in the FATF recommendations.[65] Such control provides a balanced and proportional approach, ensuring technical advantages and a high degree of transparency in the field of alternative economies and social entrepreneurship (as per the legislative resolution of the European Parliament on April 19, 2018).[66]

However, a careful examination of recent FATF standards regarding virtual assets in relation to the framework established by the 5th Directive on combating money laundering reveals that the existing regime still deviates from what is currently considered the international 'standard' for combating money laundering from criminal activities and the financing of terrorism concerning crypto-assets. The initial observation is that the definition of 'virtual currencies' in the 5th Directive on Combating Money Laundering from Criminal

and terrorist financing affecting the internal market and relating to cross-border activities' SWD (2019) 650 final, 234.

[59] Houben and Snyers (n 5) 2.

[60] FATF, 'FATF Report to G20 Leaders' Summit' (2019) 6, <https://www.fatf-gafi.org/media/fatf/content/images/G20-June-2019.pdf> accessed 10 December 2023.

[61] FATF, 'Updated Guidance for a Risk-Based Approach to Virtual Assets and Virtual Asset Service Providers' (2021) 17 <https://www.fatf-gafi.org/media/fatf/documents/recommendations/Updated-Guidance-VA-VASP.pdf> accessed 10 December 2023.

[62] FATF, 'Guidance for a Risk-based Approach to Virtual Currencies' (2015) (n 29) 46.

[63] FATF, 'Guidance for a Risk-Based Approach to Virtual Assets and Virtual Asset Service Providers' (2019) 6 <https://www.fatf-gafi.org/media/fatf/documents/recommendations/RBA-VA-VASPs.pdf> accessed 10 December 2023.

[64] FATF, 'FATF Report to G20 Leaders' Summit' (n 60) 7.

[65] Legal entities should be licensed or registered in the jurisdiction of their establishment or formation, while natural persons should be licensed or registered in the jurisdiction where their business is headquartered. See FATF, 'Guidance for a Risk-Based Approach to Virtual Assets and Virtual Asset Service Providers' (2019) (n 63) 22.

[66] FATF, 'FATF Report to G20 Leaders' Summit' (n 60) 7. Commission, 'Commission SWD accompanying Report on the assessment of the risk of money laundering' (n 58) 103.

Activities is narrower than the corresponding FATF definition. It only covers so-called 'cryptocurrencies' and does not encompass other types of virtual assets. This implies that only cryptocurrencies, and no other virtual assets, can be subject to confiscation as proceeds from criminal activities and money laundering.

The second observation[67] is that many participants in the crypto-assets market do not fall within the regulatory scope of the 5th Directive on combating money laundering from criminal activities. Several activities of virtual assets service providers, as defined by the FATF, remain unregulated under the 5th Directive, leaving blind spots in the fight against money laundering and terrorism financing. Specifically, the activities covered by FATF recommendations but not by the 5th Directive on combating money laundering include:[68]

a) Platforms that provide only cryptocurrency-to-cryptocurrency exchange services (i.e., virtual to virtual assets);
b) Platforms that facilitate the transfer of crypto-assets as intermediaries;
c) Individuals actively involved in offering and selling crypto-assets issued by an issuer.

When the 5th Directive on combating money laundering was conceived, it appears that the European legislator did not pay attention to the existence of these factors and the potential risks they might pose.

Furthermore, vigilance regarding these risks has intensified, both among regulatory authorities and at the national level by Member States[69]. To align the European framework for combating money laundering with the modern reality of crypto-assets, the EU should consider a series of regulatory actions. Given the FATF's definition of virtual assets, one initial regulatory action to be considered is expanding the scope of the definition of virtual currencies. This would allow for the confiscation of a broader range of crypto-assets, addressing gaps and vulnerabilities that criminal organizations could exploit to retain their illicit proceeds. Determining how to apply the existing legislative framework when a crypto-asset falls within the regulatory perimeter is not always straightforward.[70]

In June 2019, FATF adopted an Interpretive Note for Recommendation 15 (INR.15) to elucidate the application of FATF requirements concerning virtual assets and virtual assets service providers. Subsequently, FATF conducted two assessments to evaluate the implementation of the revised FATF standards for virtual assets by jurisdictions and the private sector. These assessments revealed progress on the part of both the public and private sectors, yet underscored the need for substantial efforts to achieve global implementation. Following the second 12-month review in June 2021, FATF committed to prioritizing the implementation of FATF Standards on Virtual Assets. In line with this commitment, FATF released an Updated Guidance for a risk-based approach to virtual assets and virtual assets

[67] Houben and Snyers (n 5) 76-80; Directive (EU) 2018/1673 of the European Parliament and of the Council of 23 October 2018 on combating money laundering by criminal law [2018] OJ L284/22 (Directive 2018/1673), preamble recital 6.
[68] Commission, 'Commission SWD accompanying Report on the assessment of the risk of money laundering' (n 58) 103.
[69] ibid.
[70] European Securities and Markets Authority, 'Advice on Initial Coins Offerings and Crypto-Assets' (2019) 37 <https://www.esma.europa.eu/sites/default/files/library/esma50-157-1391_crypto_advice.pdf> accessed 10 December 2023.

service providers in October 2021, aiming to provide clarifications for the assistance of jurisdictions in effectively implementing FATF's R.15/INR.15 requirements.[71]

To ensure the ongoing relevance of current anti-money laundering and counter-terrorist financing (AML/CFT) Standards, FATF monitors the developments in DeFi, with a specific focus on the emergence of genuinely decentralized DeFi entities. The aim is to facilitate dialogue on shared challenges in AML/CFT implementation, risk assessment, and the adoption of good practices. Simultaneously, FATF is addressing the persistent and escalating threat of criminal exploitation of Virtual Assets in the receipt and laundering of illicit proceeds from ransomware attacks. Ransomware cybercriminals are increasingly resorting to mixers, tumblers, and privacy coins for receiving and laundering illicit proceeds, with industry insights suggesting that Bitcoin remains the most commonly used virtual asset for such purposes. To counter these threats, recent consultations involving both jurisdictions and the industry have recognized the potential of blockchain analytics in tracing money laundering related to ransomware.[72]

In June 2022, FATF released a targeted update on the implementation of its Standards regarding virtual assets and virtual asset service providers, with a specific focus on the FATF's Travel Rule. This report follows the extension of FATF's anti-money laundering and counter-terrorist financing measures to virtual assets three years ago, aimed at preventing criminal and terrorist misuse of the sector. Addressing the evolving threats of money laundering and terrorist financing, the report underscores the ongoing necessity for FATF to monitor the expansion of DeFi and NFTs markets, as well as the risks associated with unhosted wallets.

In response to the report's findings, FATF strongly urges all countries to expeditiously implement the FATF's Standards on virtual assets and virtual assets service providers. To bolster these implementation efforts, FATF has outlined a series of initiatives. Firstly, FATF is actively promoting the adoption of FATF's R.15/INR.15, which includes the Travel Rule. This initiative involves facilitating discussions with Member States to address common challenges and issues related to implementation. Additionally, FATF is actively raising

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[71] The 2021 Guidance incorporates updates that specifically address six pivotal areas: 1. Clarification of Definitions: The guidance offers clarification on the definitions of virtual assets and Virtual Asset Service Providers (VASPs). 2. Application of FATF Standards to Stablecoins: Specific guidance is provided on how the FATF Standards apply to stablecoins, recognizing the unique characteristics of these assets. 3. Risk Mitigation for Peer-to-Peer Transactions: Additional guidance is outlined concerning the risks associated with peer-to-peer transactions. 3. The document also explores tools available to countries to mitigate money laundering and terrorist financing risks in this context. 4. Updated Guidance on Licensing and Registration: The 2021 Guidance includes updated recommendations on the licensing and registration processes for Virtual Asset Service Providers (VASPs). 5. Implementation of the Travel Rule: Both the public and private sectors receive additional guidance on the effective implementation of the Travel Rule. 6. Principles of Information-Sharing and Cooperation: The guidance emphasizes principles for information-sharing and cooperation among supervisors of Virtual Asset Service Providers (VASPs). This aspect aims to enhance coordination and collaboration in the regulatory landscape. These updates collectively contribute to a more comprehensive and contemporary framework for addressing challenges and risks within the evolving landscape of virtual assets and Virtual Asset Service Providers.

[72] To reduce the profitability of ransomware attacks and to mitigate its risk, it was shared that it would also be useful for FATF to 1) compile, share and publish typologies and red flag indicators of ransomware attacks and 2) strengthen international cooperation between authorities (both LEAs and supervisors) at international level; 3) continue and strengthen outreach to the private sector to inform them of relevant risks; 4) explore ways to take advantage of various sources of information including information on the blockchain and in STRs; and 5) strengthen cooperation between relevant authorities at the domestic level.

awareness by engaging with influential forums, such as G7/G20 and other high-level policy bodies. Moreover, as part of its ongoing commitment, FATF had a comprehensive review of the progress made and the remaining challenges in the implementation of FATF's Standards on virtual assets and virtual assets service providers for June 2023. This thorough assessment was designed to ensure the efficacy of measures taken and to pinpoint areas that may necessitate additional attention or refinement.

In June 2023, the Financial Action Task Force took steps to enhance its AML/CFT measures for virtual assets and virtual asset service providers, aiming to prevent criminal and terrorist misuse of the sector. However, a noteworthy observation reveals that only 30% of assessed jurisdictions mandate the licensing or registration of VASPs and practical implementation of such measures is even scarcer. This situation raises concerns as unlicensed or unregistered virtual assets service providers operating without proper oversight pose money laundering and terrorist financing (ML/TF) risks, complicating law enforcement efforts. Jurisdictions grappling with challenges in licensing or registration processes are urged to enhance supervision and impose sanctions for non-compliance.

Regardless of the regulatory approach adopted, jurisdictions are advised to actively monitor and supervise their virtual assets service providers population, ensuring strict enforcement of AML/CFT obligations. Notably, jurisdictions with established registration or licensing regimes are making commendable progress in supervising and enforcing AML/CFT obligations. The overarching message is that continuous monitoring and supervision of virtual assets service providers, irrespective of the regulatory strategy, are crucial to guarantee compliance with AML/CFT requirements.

Now marking four years since the extension of global AML/CFT standards to virtual assets and virtual asset service providers, some major virtual asset markets have implemented or are in the process of establishing AML/CFT regulations. Nevertheless, a significant concern persists, as 75% of assessed jurisdictions fall short, being either partially or non-compliant with FATF's requirements. This lag in compliance is notably prominent compared to other sectors within the financial industry. Despite this, there are positive signs of collaboration within the private sector, with certain entities working together to enhance Travel Rule compliance tools. While improvements are evident, the industry still faces challenges. The above report represents the fourth targeted review of the implementation of FATF's Standards on virtual assets, providing an updated assessment of emerging risks and market developments in this evolving field.

The EU lags international standards. European regulations for combating money laundering introduced by the 5th Directive for the Prevention of Money Laundering became outdated long before Member States were required to transpose them into their national legal systems, which was on 10 January 2020. If the EU remains inactive, Member States can take action, given their individual participation in the FATF, and amend their national legislations to comply with FATF's most recent recommendations.[73] However, such national action alone is insufficient and might create legal uncertainty across national borders. To avoid imbalances on an international scale, it is preferable to take regulatory action at a higher level.

A few months after the introduction of the 5th Directive, in October 2018, the 6th Directive on the Prevention of the Use of the Financial System for the Purposes of Money

[73] Houben and Snyers (n 5) 2.

Laundering and Terrorist Financing followed. Despite the already identified weaknesses of the 5th Directive and the gaps that were identified, the legislator does not seem to have taken them into account and rather proceeded to minimal regulations regarding crypto-assets. Specifically, in the preamble of the 6th Directive, it is recognized that 'the use of virtual currencies entails new risks and challenges from the perspective of preventing the legalization of income from illegal activities. Member states should ensure the appropriate treatment of these risks'.[74] This is a general statement that does not substantially address the emerging risks and challenges of cryptocurrencies. It can even be argued that it leaves considerable discretion to Member States to regulate as they see fit. However, such an approach may result in fragmented legal frameworks between the national legal systems of Member States.

Regarding crypto-assets, the 6th Directive states that the definition of assets includes assets of any form, including electronic or digital assets, which demonstrate ownership or rights to acquire such assets.[75] In general, the rules introduced by the 6th Directive for combating money laundering do not introduce anything new, and the adoption of a 7th Directive aimed at addressing identified risks and problems within the existing framework would not be surprising. The successive introduction of new legislations for combating the legalization of income from criminal activities in a short period of time strongly indicates the uncertainty in which the European legislator finds itself in. It seems to be struggling to coordinate with the technological developments, as the enacted legislations appear inadequate and outdated even before they are incorporated into the national legal systems.[76]

MONEYVAL had some very useful insights regarding confiscation of virtual assets. More specifically, MONEYVAL members were requested recently to provide information regarding the procedures they apply to implement interim measures for freezing and seizing virtual assets. Seven members submitted relevant information. The majority expressed their intent to seek assistance from virtual asset service providers overseeing suspected criminal proceeds in virtual assets, instructing them to freeze the assets. Some members mentioned using official or government wallets for the transfer and retention of seized virtual assets. The effectiveness of seizing and transferring virtual assets not under the control of a virtual assets service providers, which hold the wallet keys, is dependent on law enforcement agencies obtaining the wallet keys, thereby gaining control of the virtual assets. MONEYVAL members also mentioned utilizing Financial Intelligence Unit (FIU) postponement powers to promptly freeze assets during the pre-trial stage, awaiting the application of more formal means of asset freezing and seizure. Some members indicated attempts to directly engage foreign virtual assets service providers for assistance in seizing and freezing assets, acknowledging the significant dependency on the willingness of VASPs to cooperate voluntarily.[77]

The focal point of recent legislation pertaining to virtual assets is the Markets in Crypto-Assets Regulation. This legislation emerged as the EU's response to the policy

[74] Directive 2018/1673 (n 67) Title 6, Preamble.
[75] ibid Article 2(2).
[76] European Banking Authority, 'Report with advice for the European Commission on crypto-assets' (2019) <https://eba.europa.eu/eba-reports-on-crypto-assets> accessed 10 December 2023; European Securities and Markets Authority (n 70) 20-21.
[77] MONEYVAL Secretariat, Directorate General of Human Rights and Rule of Law, Council of Europe, 'Money Laundering and Terrorist Financing Risks in the world of virtual assets' (2023) Typologies Report, 24 <https://rm.coe.int/moneyval-2023-12-vasp-typologies-report/1680abdec4> accessed 10 December 2023.

discussions triggered by the Libra proposal in June 2019. The debate on whether the crypto-assets market should fall under EU regulation leaned towards an unequivocal affirmative stance. The chosen instrument, a Regulation, clearly underscores the gravity of regulatory intentions. Its objective is to fill a significant regulatory void and establish a harmonized approach to crypto-assets across the EU Single Market.[78]

It is a crucial component of the EU's Digital Finance Strategy and is designed to offer legal certainty for unregulated crypto-assets.[79] The MiCA Regulation, proposed by the Commission, stands as the first comprehensive regulation directly addressing crypto-assets. Its primary objectives are to foster innovation, preserve financial stability, maintain market integrity, and safeguard investors from potential risks. MiCA specifically governs a distinct asset class, crypto-assets, which differs from digital securities, such as stocks and bonds. Formulated in conjunction with existing legislative frameworks, MiCA's scope encompasses the entire crypto-asset ecosystem, leaving no crypto-asset unregulated. The regulation is driven by four main goals:

a) to establish legal certainty with a robust legal framework, clearly defining rules applicable to all crypto-assets not covered by existing financial legislation;
b) to create a legal framework that is both secure and proportionate, fostering innovation and ensuring fair competition;
c) to implement sufficient levels of consumer and investor protection, mitigating the potential risks posed by crypto-assets to the internal market;
d) to ensure financial stability, with a specific mention of stablecoins by the European Commission, recognizing their potential to gain widespread acceptance and pose systemic risks.[80]

7 THE RISK OF ABUSIVE SELECTION OF THE MOST FAVORABLE REGIME (FORUM SHOPPING)

Within the same framework of analysis of the issues regarding cryptocurrencies, there is the risk of abusive selection of the most favorable regime. This arises from the possible divergent incorporation of existing definitions within national laws. Additionally, in the analysis of the European banking authority and the European securities and markets authority, it is mentioned that a significant number of crypto-assets and related activities do not fall under the scope of European financial services legislation.[81] Each Member State is fundamentally free to establish its rules regarding 'unregulated' assets.[82] Some EU Member States have

[78] Dirk Andreas Zetzsche, Filippo Annunziata, Douglas W Arner, and Ross P Buckley, 'The Markets in Crypto-Assets Regulation (MICA) and the EU Digital Finance Strategy' (2020) European Banking Institute Working Paper Series No. 2020/77, University of Luxembourg Law Working Paper Series No. 2020-018, University of Hong Kong Faculty of Law Research Paper No. 2020/059 <https://ssrn.com/abstract=3725395> accessed 10 December 2023.
[79] Tina van der Linden and Tina Shirazi, 'Markets in crypto-assets regulation: Does it provide legal certainty and increase adoption of crypto-assets?' (2023) 9 Financial Innovation 22 <https://jfin-swufe.springeropen.com/articles/10.1186/s40854-022-00432-8> accessed 10 December 2023.
[80] van der Linden and Shirazi (n 79) 22.
[81] European Banking Authority, 'Report with advice for the European Commission on crypto-assets' (n **Fel! Bokmärket är inte definierat.**), European Securities and Markets Authority (n 70) 20-21.
[82] Claude Brown, Tim Dolan, and Karen Butler, 'Crypto-Assets and Initial Coin Offerings' in Jelena Madir, *Fintech: Law and Regulation* (Edward Elgar Publishing 2019) 79.

implemented such regulation since late 2018 because 'unregulated' assets pose similar risks to other crypto-assets and those subject to EU legislation on financial services.[83]

These national initiatives are not consistent with each other, leading to divergent approaches within the EU and providing the opportunity for an abusive selection of the most favorable jurisdiction.[84] A crypto-asset regulated by legislation in one jurisdiction may not be regulated in another. This practice can pose a challenge both for combating money laundering and for the overall development of legal schemes for crypto-assets.[85] Cryptocurrency assets constitute an international phenomenon. They are created by private actors in various countries around the world, possess international reach and infrastructure, and are readily accessible, transferable, exchangeable, and tradable from anywhere in the world. As a result, regulatory challenges are not confined to European borders but extend much further. To address these challenges, regulatory authorities' intervention is necessary. In some countries, legislators have already taken action or intend to do so. The problem is that these national initiatives are not aligned with each other, leading to an abusive selection of the most favorable regime. To tackle this issue, regulatory control over cryptocurrency assets should be exercised at European level, preferably in alignment with international standards.

Money laundering and terrorism financing, like cryptocurrency assets, are not limited by European borders.[86] Criminals and terrorists identify gaps and seek 'loopholes' in the regulatory framework to carry out money laundering activities. Therefore, if a country or region has more favorable anti-money laundering rules for cryptocurrency assets compared to the EU, illicit activities are likely to shift to that region, creating gateways for money laundering. The same unquestionably applies to money laundering and terrorism financing activities involving cryptocurrency assets.[87] If consistent anti-money laundering standards were upheld in all regions, the chances of effectively eradicating such activities would be much higher. Hence, it is advisable to establish international standards for combating money laundering through the use of cryptocurrencies. The FATF, as an international policymaking body, aims to achieve precisely this goal. EU Member States should continue to contribute to these efforts, while international standards set by the FATF should continue to be incorporated into European law promptly and coherently, ensuring compliance throughout the internal market and the international financial system.[88]

Instances may arise where virtual assets, deemed proceeds of crime in one country, are located in a foreign jurisdiction. In such scenarios, legal enforcement authorities encounter additional obstacles in freezing or seizing these virtual assets, as they are not under the control of virtual assets service providers established within the jurisdiction. This highlights

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[83] Steven Maijoor, 'Crypto-Assets: time to deliver in Keynote speech 3rd Annual FinTech Conference' (2019) 6 <https://www.esma.europa.eu/sites/default/files/library/esma71-99-1120_maijoor_keynote_on_crypto-assets_-_time_to_deliver.pdf> accessed 10 December 2023.

[84] European Banking Authority, 'Report with advice for the European Commission on crypto-assets' (n **Fel! Bokmärket är inte definierat.**) 15.

[85] Brown, Dolan, and Butler (n 82) 79.

[86] Council of the European Union, 'Council Conclusions on strategic priorities on anti-money laundering and countering the financing of terrorism' (2019) 14823/19, 4 <http://data.consilium.europa.eu/doc/document/ST-14823-2019-INIT/en/pdf> accessed 10 December 2023.

[87] Brown, Dolan, and Butler (n 82) 79.

[88] Houben and Snyers (n 5) 2.

the crucial role of effective international cooperation in pursuing such cases and executing asset freezes or seizures. Jurisdictions offering practical insights on handling such situations frequently cited the use of international cooperation channels, such as Mutual Legal Assistance (MLA). Respondents expressed skepticism about the efficiency of these mechanisms in ensuring the timely seizure or freezing of virtual assets.[89]

8 CONCLUSIONS

In conclusion, four years after enhancing its standards to address virtual assets and virtual asset service providers, the global implementation of these measures remains notably ineffective. Nearly three-quarters of jurisdictions exhibit only partial or no compliance with FATF requirements, with many jurisdictions yet to implement fundamental measures. A significant concern arises from the fact that over half of the survey respondents have not initiated the implementation of the Travel Rule, a crucial FATF requirement aimed at preventing the transfer of funds to sanctioned individuals or entities. This lack of regulation creates substantial loopholes for criminal exploitation, emphasizing the urgent need to address gaps in the global regulation of virtual assets.

Recognizing the severity of the situation, the FATF has called upon all countries to promptly apply Anti-Money Laundering/Countering the Financing of Terrorism (AML/CFT) rules to virtual asset service providers, without further delay. In a report published on 27 June, the FATF urged countries to expeditiously implement its Recommendations on virtual assets and virtual assets providers, including the Travel Rule, to close these regulatory loopholes. Looking ahead, in the first half of 2024, the FATF plans to publish a table illustrating the steps taken by FATF member jurisdictions and other jurisdictions with materially important virtual assets service providers activities toward implementing Recommendation 15. This underscores the ongoing commitment to monitor and enhance the regulatory landscape surrounding virtual assets on a global scale.

The FATF has consistently updated its standards on asset recovery as part of its overarching commitment to bolster countries' efforts in depriving criminals of their unlawfully obtained gains. In pursuit of this objective, the FATF is set to introduce new mechanisms that countries should adopt to efficiently freeze, seize, and confiscate criminal assets, both at the domestic level and through international collaboration. The Plenary has reached a consensus to commence work on revising Recommendations 4 (non-conviction based confiscation) and 38 (prompt action in response to requests by countries to identify, freeze, and seize property). The intended approval of these revisions is slated for October 2023, reflecting the FATF's ongoing dedication to enhancing global measures for combating financial crime and promoting asset recovery.[90]

Blockchain tools have played a crucial role in supporting successful enforcement cases, implementing targeted financial sanctions, and taking other actions to disrupt ransomware financing. However, industry stakeholders acknowledge persistent challenges, particularly arising from the use of privacy coins, chain-hopping via non-compliant virtual asset service providers, and unhosted wallets. To effectively address these challenges in moving forward,

[89] MONEYVAL, 'Money Laundering and Terrorist Financing Risks in the world of virtual assets' (n 77) 36.
[90] Bruce Zagaris, 'Money Laundering, Bank Secrecy, and International Human Rights' (2023) 39(7) International Enforcement Law Reporter 240.

it is imperative for both jurisdictions and the private sector to implement FATF's Standards on virtual assets and virtual asset service providers. This implementation is crucial for enabling the private sector to identify illicit actors and detect suspicious transactions.

While the MiCA Regulation represents an ambitious legislative initiative as referred to above, there are notable areas that require refinement. There is an absence of a systematic approach to EU law, with a need for the incorporation of thresholds and concepts from other EU law sources into MiCA. There is also a notable gap in providing a framework for supervisory cooperation concerning truly global stablecoins. On a broader scale, MiCA is part of a comprehensive approach deemed essential, yet substantial revisions are necessary to achieve its varied goals. MiCA aims to establish legal certainty by creating a uniform framework directly applicable in Member States. Institutions, such as the ECB have welcomed regulation for crypto-assets, and MiCA applies to anyone offering crypto-assets or providing crypto-asset services in the EU. The regulation, in Article 2, specifies that it applies to currently unregulated crypto-assets outside the scope of existing financial services legislation, ensuring continuity for those covered by MiFID II/MiFIR. Despite the current challenges, there is hope that, with amendments, the MiCA Regulation will eventually contribute to a regulated environment for crypto-assets, allowing European citizens and businesses to safely benefit from their advantages, aligning with the Commission's Digital Finance Package objectives.

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DOI: https://doi.org/10.2139/ssrn.3725395

FINANCIAL TOOLS

A WAY TO APPROACH THE RULE OF LAW?

HANA KOVÁČIKOVÁ*

The rule of law is the hot topic of these days. Especially Poland and Hungary have been for the past eight years proving that they are not afraid to backslide from the values on which the Union is founded, the rule of law among them. The lengthy process on determining whether there exists a 'clear risk of serious breach' of the fundamental values by these two Member States, while having a few judgments of the Court of Justice of the EU, proves that the political sanctions envisaged in Article 7 TEU are not an effective tool in dealing with such Member States. Accordingly, this article intends to show the ineffectiveness of political tools and to inquire whether the financial tools contained in the Conditionality Regulation, Common Provision Regulation, and Resilience and Recovery Regulation could be a more effective solution in this regard.

1 INTRODUCTION

'No man is above the law and no man is below it'.[1] 'Lady Justice is blind – she will defend the Rule of Law wherever it is attacked'.[2] 'The EU cannot survive without the rule of law'.[3] 'The rule of law defines the very identity of the European Union as a common legal order'.[4]

These are just a few quotes. However, they aptly describe the importance of this crucial legal principle. We can see the dramatic transformation it has experienced during the past 30 years. From a simple confirmation of the attachment of the Member States to the principle of the rule of law in the preamble of the Maastricht Treaty on European Union[5] it has become a value on which the Union is founded, which is common to all of its Member States (MSs), as stipulated in Article 2 of the Lisbon Treaty on European Union[6] (TEU). The EU is now not just an economic project, but rather a project driven by values,[7] the rule of law included.

However, understanding its meaning requires a more complex approach. As pointed out by Schroeder, '[t]he rule of law constitutes a conceptual puzzle in the Union legal order,

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[1] Gerhard Peters and John T Woolley, 'Theodore Roosevelt, Third Annual Message Online' (*The American Presidency Project*) <https://www.presidency.ucsb.edu/node/206201> accessed 10 December 2023.

[2] Ursula von der Leyen, 'Opening Statement in the European Parliament Plenary Session by Ursula von der Leyen, Candidate for President of the European Commission' (*European Commission press corner*, 16 July 2019) <https://ec.europa.eu/commission/presscorner/detail/en/speech_19_4230> accessed 10 December 2023.

[3] Helsinki Rule of Law Forum, 'A Declaration on the Rule of Law in the European Union' (*Verfassungsblog*, 18 March 2022) <https://verfassungsblog.de/a-declaration-on-the-rule-of-law-in-the-european-union/> accessed 16 September 2023.

[4] Case C-156/21 *Hungary v Parliament and Council* EU:C:2022:97 para 127.

[5] Treaty on European Union [1992] OJ C191/1.

[6] Consolidated Version of the Treaty on European Union [2012] OJ C326/13.

[7] Stephen Weatherill, *Law and Values in the European Union* (1st edn, Oxford University Press 2016) 393.

since there exist different conceptions of its significance and its content beyond its basic meaning that any form of public power must be subordinated to some kind of primary, unchangeable norms, and therefore this principle cannot be defined conclusively and it may evolve over time'.[8] Hofmann calls it an 'umbrella principle' with some core content and numerous (sub-principles).[9]

In this regard, the Court of Justice of the European Union (CJEU) has stressed the material scope of the rule of law by saying that '[t]he EU institutions are subject to judicial review of the compatibility of their acts with the Treaty as well as with the general principles of law which include fundamental rights'[10] and that the rule of law contains legal principles, such as effective judicial protection before independent courts,[11] principles of legality,[12] legal certainty and protection of legal expectations,[13] prohibition of arbitrariness or disproportionate intervention of public authorities,[14] and separation of powers.[15] As pointed out by Bárd, 'the effects of rule of law backsliding extend way beyond the borders of the state in which rule of law decline takes place and spill over to the European Union, too.'[16] The rule of law, as an integral part of EU values, co-defines the very identity of the EU as a common legal order. In this regard, the 'EU must be able to defend those values'.[17]

The question is whether the EU has done its homework and provides effective tools to ensure respect for the rule of law. In this regard, the CJEU stated that the EU

> [h]as developed a variety of instruments and processes that promote the rule of law and its application, including financial support for civil society organisations, the European Rule of Law Mechanism and the EU Justice Scoreboard, and provides an effective response from Union institutions to breaches of the rule of law through infringement proceedings and the procedure provided for in Article 7 TEU.[18]

But is this really true? Are these tools provided by the EU really effective? All of them? Or only some of them?

Traditional legal tools - the infringement proceedings (Articles 258, 260 TFEU) - can be activated only when a Member State has failed to fulfil a specific obligation under the treaties. However, neither TEU nor TFEU directly stipulates the obligation to comply with the rule of law. Such obligation is identified indirectly and only subsequently through the interpretations of the CJEU provided in preliminary rulings relating to other obligations.[19]

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[8] Werner Schroeder, 'The Rule of Law As a Value in the Sense of Article 2 TEU: What Does It Mean and Imply?' in Armin von Bogdandy et al, *Defending Checks and Balances in EU Member States: Taking Stock of Europe's Actions* (Springer Link 2021) 122.
[9] Herwig CH Hofmann, 'General Principles of EU Law and EU Administrative Law' in Catherine Barnard and Steve Peers (eds), *European Union Law* (2nd edn, Oxford University Press 2017) 208.
[10] Case C-50/00 *Unión de Pequeños Agricultores* EU:C:2002:462 para 38.
[11] Case C-896/19 *Repubblika* EU:C:2021:311 para 51.
[12] Case C-496/99 P *Commission v CAS Succhi di Frutta* EU:C:2004:236 para 63
[13] Joined Cases 212 to 217/80 *Meridionale Industria Salumi and others* EU:C:1981:270 para 10.
[14] Joined Cases 46/87 and 227/88 *Hoechst v Commission* EU:C:1989:337 para 19.
[15] Case C-477/16 PPU *Kovalkovas* EU:C:2016:861 para 36.
[16] Petra Bárd, 'In Courts We Trust, or Should We? Judicial Independence as the Precondition for the Effectiveness of EU Law' (2021) 27 European Law Journal 185, 187.
[17] Case C-157/21 *Poland v Parliament and Council* EU:C:2022:98 para 145.
[18] ibid para 14.
[19] See to that effect case C-64/16 *Associação Sindical dos Juízes Portugueses* EU:C:2018:117 or C-216/18 PPU *Minister for Justice and Equality (Deficiencies in the system of justice)* EU:C:2018:586.

Most cases in this regard relate to the second subparagraph of Article 19(1) TEU, establishing the obligation for MSs to ensure effective legal protection in the fields covered by Union law[20] which 'gives concrete expression to the value of the rule of law affirmed in Article 2 TEU'.[21] The effectiveness of this tool can be pre-illustrated by the well-known case of Poland (C-204/21).[22] As the Commission stated in its Press Release of 29 April 2020,[23] a dialogue on this matter started in January 2016, while the infringement procedure in the form of a Letter of Formal Notice was launched in 2020.[24] It was followed by the Reasoned Opinion [30 October 2020], Additional formal notice [3 December 2020] and Additional reasoned opinion [27 January 2021]. As Poland did not comply with the recommendation of the Commission, this institution referred the case to the CJEU in March 2021. From 2021, it took four interim measures[25] and one judgment [5 June 2023] just to determine that the MS had failed to fulfil its obligations to ensure effective legal protection in the fields covered by EU law. Information on whether Poland has in fact fulfilled its obligations and complied with obligations specified in the judgment of 5 June 2023 is not yet available. By now, the Commission did not submit an action pursuant the Article 260 TFEU against Poland in this regard. However, seven years of operationalisation of Article 258 TFEU can hardly be considered as an effective tool to protect the rule of law.

Therefore, the author's attention in this article will focus on the newer political and financial tools. To find out the answers to the questions on their effectiveness, the author formulated the following hypotheses:

1) Political tools to ensure compliance with the rule of law principle are not effective.
2) Financial tools to ensure compliance with the rule of law are effective.

These presumptions originate from the conclusion that new (financial) tools were developed as a consequence of the insufficient performance of the existing political and legal tools. In this article, the author compares the already existing political and legal rule of law instruments to the new monetary instruments. Attention is given to the threefold conditionality, which developed in the post NGEU legal landscape and relates to EU budget, EU Funds, and Resilience and Recovery Facility.

To verify the presented hypotheses, the author has used the usual scientific research methods, such as doctrinal analysis, case-law study, comparison, deduction, abstraction, and synthesis. The effectiveness of particular tools is demonstrated in the case studies of Poland and/or Hungary.

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[20] cf. *Associação Sindical dos Juízes Portugueses* (n 19) para 32 and the cases cited therein.
[21] Case C-192/18 *Commission v of Poland* EU:C:2019:924 para 98, Case C-619/18 *Commission v Poland* EU:C:2019:531 para 47, *Associação Sindical dos Juízes Portugueses* (n 19).
[22] Case C-204/21 *Commission v Poland* EU:C:2023:442.
[23] Commission, 'Rule of Law: European Commission launches infringement procedure to safeguard the independence of judges in Poland' (Press Release) (2023) IP/20/772.
[24] Under the No INFR(2020)2182.
[25] Case C-204/21: Order of the Vice-president of the Court of 14 July 2021 (EU:C:2021:593), Order of the Vice-president of the Court of 6 October 2021 (EU:C:2021:834), Order of the Vice-president of the Court of 27 October 2021 (EU:C:2021:878), and Order of the Vice-president of the Court of 21 April 2023 (EU:C:2023:334).

2 A POLITICAL TOOLBOX

MSs officially share the same values[26] and commit to promote them.[27] As pointed out by the CJEU, in its well-known Opinion 2/13, 'that premiss implies and justifies the existence of mutual trust between the Member States that those values will be recognised and, therefore, that the law of the EU that implements them will be respected'.[28] However, sometimes it may appear that this premise is valid only during the accessing process and for some time after the accession. Such a negative perception was confirmed, for example, by the results of the 2019 Eurobarometer survey on Rule of Law in the EU.[29] Out of 27,655 respondents across the EU, i.e. over 80%, thought that the situation in their country regarding the respect of the principles of rule of law[30] needs (at least some) improvement.[31]

Therefore, a political toolbox has undergone a scrutiny to find out whether currently designed tools are sufficiently deterring MSs from rule of law backsliding.

2.1 ARTICLE 7 TEU

Article 7 TEU is the essential political tool to ensure MSs compliance with EU values referred to in Article 2 TEU. To this end, it establishes three phases of political pressure. In the first phase, the Council may determine that there is a clear risk of a serious breach of these values by a MS.[32] In the second phase, the European Council may determine the existence of a serious and persistent breach of these values by a MS.[33] Finally, in the third phase, the Council may, after adopting the infringement decision by the European Council, decide to suspend certain of the rights deriving from the application of the Treaties to the MS in question.[34] Despite the Commission labelling Article 7 TEU as a 'nuclear button', academia remains rather sceptic on its real power.

For example, as highlighted by von Bogdandy,[35] defending values on the basis of Article 7 TEU is 'completely under control of the governments of the MSs united in the Union's institutions' which might not be willing to bear such a [political] responsibility. Furthermore, a very high threshold for a voting quorum 'might leave EU values without defence.'[36] Kochenov also concludes, as regards the effective enforcement of the rule of law,

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[26] Art 2 TEU.
[27] Art 49 TEU.
[28] Opinion 2/13 *Adhésion de l'Union à la CEDH* EU:C:2014:2454 para 168.
[29] European Union, 'Special Eurobarometer 489 "Rule of Law". Summary' (2019) <https://europa.eu/eurobarometer/surveys/detail/2235> accessed 10 December 2023.
[30] Assessment included the perception of 17 factors: equality before the law; clarity and stability of the law; ease in following how parliament adopts law; lawmakers act in the public interest; independent control on laws; clarity of public authorities' decisions; independent review of public authorities' decisions; unbiased decisions of public authorities; making decisions in the public interest; acting on corruption; codes of ethics for politicians; access to an independent court; length or cost of court proceedings; the independence of judges; the proper investigation of crimes; respect for and application of court rulings; codes of conduct for politicians.
[31] ibid 9.
[32] Art 7(1) TEU.
[33] Art 7(2) TEU.
[34] Art 7(3) TEU.
[35] Armin von Bogdandy, 'Towards a Tyranny of Values?' in Armin von Bogdandy et al, *Defending Checks and Balances in EU Member States: Taking Stock of Europe's Actions* (Springer Link 2021).
[36] von Bogdandy, 'Towards a Tyranny of Values?' (n 35) 83.

that there is no room for Article 7 TEU.[37] He refers to the non-binding character of the recommendation presumed in Article 7(1), as well as the lack of political will to achieve the required unanimity prescribed in Article 7(2) or the qualified majority prescribed in Article 7(3). Finally, Theuns correctly reasons that the wording of Article 7 TEU in all 3 sections refers, as regards the action of the Council or European Council, only to the *possibility* but not to the obligation to determine whether there exists a threat or already a breach of the EU values, and the Council *may* decide on the suspension of the rights derived from the application of the Treaties to the MS in question.[38]

Such a critical approach can be verified in the cases against Poland and Hungary. Both countries are known to have problems with the rule of law, especially in regard to the independence of judges.[39] The Commission has already pushed a *nuclear button*, initiating a procedure according to Article 7(1), against Poland[40] [2017] and Hungary[41] [2018]. Despite the fact that both countries have already had six hearings,[42] the Council has not yet adopted its decision on whether *there exists a clear risk of a serious breach* by these countries of the rule of law. Be that as it may, the worst scenario for both countries would mean the issuance of another (nonbinding) recommendation.

It is needless to say that the stronger tools presented in Articles 7(2) and 7(3) of the TEU have not yet been activated.

Article 7 TEU therefore provides a decorative rather than an effective tool in terms of compliance with the rule of law. However, these observations are not new. The European Parliament described the situation already ten years ago as without 'clear and common benchmarks' and pointed out that 'in too many instances there is permanent inertia and the Treaties and European values are not observed'.[43] Therefore, it was inevitable to develop other tool(s) - effective enough to persuade Member States to follow the rules. The answer of the Commission to this came in the form of the Rule of Law Framework[44] and the Rule of Law Conditionality Mechanism.

2.2 RULE OF LAW FRAMEWORK

The Rule of Law Framework is meant to work as a complementary tool to the other existing mechanisms. Its purpose is to prevent MS from developing backsliding from the rule of law into the emergence of systemic threats to the rule of law at the level of the 'clear risk' or

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[37] Dimitry Kochenov, 'Article 7: A Commentary on a Much Talked-About "Dead" Provision' in Armin von Bogdandy et al, *Defending Checks and Balances in EU Member States: Taking Stock of Europe's Actions* (Springer Link 2021).

[38] Tom Theuns, 'The Need for an EU Expulsion Mechanism: Democratic Backsliding and the Failure of Article 7' (2022) 28 Res Publica 693.

[39] See to this effect for example cases C-619/18 R *Commission v Poland* (n 21), C-192/18 *Commission v Poland* (n 21), C-204/21 *Commission v Poland* (n 22), C-288/12 *Commission v Hungary* EU:C:2014:237.

[40] Commission, 'Reasoned proposal in accordance with Article 7(1) of the Treaty on European Union regarding the Rule of Law in Poland' (Proposal) COM (2017) 835 final

[41] European Parliament, 'A proposal calling on the Council to determine, pursuant to Article 7(1) of the Treaty on European Union, the existence of a clear risk of a serious breach by Hungary of the values on which the Union is founded' P8_TA (2018)0340.

[42] European Council, 'Rule of Law' (Last reviewed on 28 November 2023) <https://www.consilium.europa.eu/en/policies/rule-of-law/> accessed 10 December 2023.

[43] European Parliament, 'Situation of fundamental rights in the EU (2013-14)' (Resolution) P8_TA (2015) 0286.

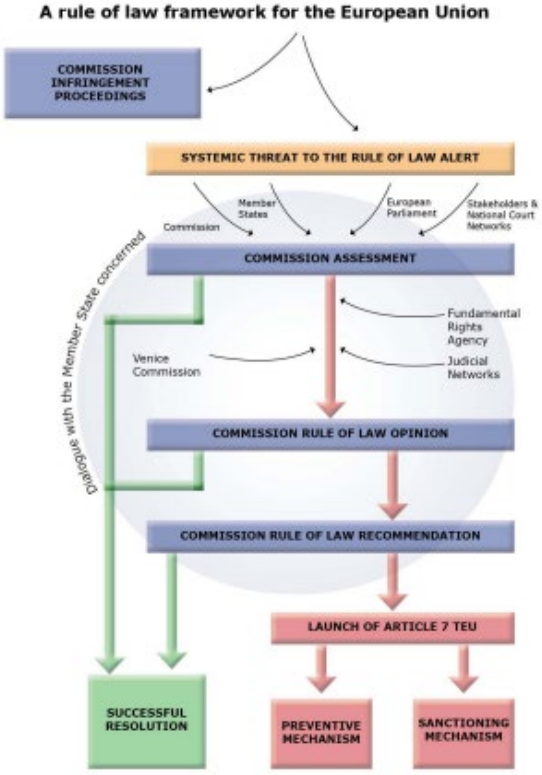
[44] Commission, 'A new EU Framework to strengthen the Rule of Law' COM (2014) 158 final.

'serious breach' and to prevent the use of 'Article 7 nuclear button'. These goals should be reached through the individual dialogue held between the Commission and the MS concerned. As explained by the Commission,

> [t]he framework will be activated in situations where authorities of a MS are taking measures or are tolerating situations which are likely to systematically and adversely affect the integrity, stability pr the proper functioning of the institutions and the safeguard mechanisms established at national level to secure the rule of law.[45]

However, it does not specify the clear criteria for its application, nor when the framework must be activated. Furthermore, the whole procedure ends again with a (non-binding) recommendation. The whole system depends, again, on the goodwill of the MS concerned. If the MS concerned does not comply with the recommendation of the Commission, the only possible (but not obligatory) "sanction" is the triggering of Article 7 TEU (*Figure 1*).

Figure 1: Scheme of Rule of Law Framework



Source: <https://commission.europa.eu/system/files/2021-08/com_2014_158_annexes_en.pdf> accessed 10 December 2023

The effectiveness of these political tools has already been tested on Hungary and Poland. In 2015, the Hungarian Prime Minister Orbán raised concerns relating to the rule of law by his repeated statements on initiation of a debate on potential re-establishment of the

[45] Commission, 'A new EU Framework' (n 44) 6.

death penalty in Hungary and by launching a nation-wide debate on immigration, whose narrative connected migration with security threats.

The European Parliament (EP) therefore urged the Commission to activate the assessment stage of the Rule of Law Framework and to evaluate the emergence of a systemic threat to the rule of law in Hungary.[46] Public consultations were followed by the adoption of various laws that 'rendered access to international protection very difficult and have unjustifiably criminalised refugees, migrants and asylum seekers'.[47] In December 2015, the EP reiterated its position and blamed the Commission for focusing mainly on 'marginal, technical aspects of the legislation while ignoring the trends, patterns and combined effect of the measures on the rule of law and fundamental rights' and repeatedly called for action under the Rule of Law Framework. However, the Commission concluded that the conditions for activating the framework were not met and decided to open an infringement procedure instead.[48] In 2017, the EP adopted a third Resolution on the situation in Hungary where it criticised both the development leading to a serious deterioration of the rule of law in the MS as well as the Commission for failing to act effectively to protect the rule of law in the EU.[49] Due to the laws adopted in Hungary, the EP's increasing concerns related to

> [t]he functioning of the constitutional and electoral system, independence of the judiciary and of other institutions and the rights of judges, corruption and conflicts of interest, privacy and data protection, freedom of expression, including media pluralism, academic freedom, freedom of religion, freedom of association, the right to equal treatment, including LGBTIQ rights, the rights of persons belonging to minorities, including Roma and Jews, and protection against hateful statements against such minorities, the fundamental rights of migrants, asylum seekers and refugees, economic and social rights and many worrying allegations of corruption and conflicts of interest. As the Commission still had not reacted, in 2018 the EP initiated the Article 7(1) TEU Procedure itself.[50]

In 2022, the EP reiterated its concerns and deplored 'the inability of the Council to make meaningful progress in the ongoing Article 7(1) TEU procedure'.[51] At the time of writing, the Council has not adopted a decision yet.

Likewise, Poland raised concerns related to the rule of law in 2015. The Commission's concerns related to many aspects, such as the composition of the Constitutional Tribunal; the reduction of the mandate of particular judges; the independence of the judges and the effectiveness of the constitutional review of new legislation, which was enacted in 2016. It led to the adoption of the Opinion concerning the rule of law in Poland, adopted by the

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[46] European Parliament 'Situation in Hungary' (Resolution) [2015] P8_TA(2015)0227.
[47] European Parliament, 'Situation in Hungary: follow up to the European Parliament Resolution of 10 June 2015' (Resolution) [2015] P8_TA(2015)0461.
[48] ibid [G], [H]. The Commission held the procedure under No INFR(2015)2201. In 2018, the case was referred to the CJEU and decided by its judgment of 17 December 2020, C-808/18 *Commission v Hungary* EU:C:2020:1029. Information whether Hungary has complied with the judgment is not available.
[49] European Parliament, 'Situation in Hungary' (Resolution) [2017] P8_TA(2017)0216.
[50] European Parliament, 'The situation in Hungary: A proposal calling on the Council to determine, pursuant to Article 7(1) of the Treaty on European Union, the existence of a clear risk of a serious breach by Hungary of the values on which the Union is founded' (Resolution) [2018] P8_TA-PROV(2018)0340.
[51] European Parliament, 'Existence of a clear risk of a serious breach by Hungary of the values on which the Union is founded' (Resolution) [2022] P9_TA(2022)0324.

Commission in 2016.[52] This was followed by the Commission Recommendation (EU) 2016/1374 of 27 July 2016,[53] Commission Recommendation (EU) 2017/146 of 21 December 2016,[54] Commission Recommendation (EU) 2017/1520 of 26 July 2017[55] and Commission Recommendation (EU) 2018/103 of 20 December 2017.[56] Within these two years, the Commission had held a continuous dialogue with Poland and exchanged more than 25 letters with the Polish authorities on this matter. However, Poland failed to adopt appropriate measures to tackle the identified systemic threats and the Commission considered that the situation of systemic threat to the rule of law even worsened. Therefore, in December 2017, the Commission initiated the Article 7(1) TEU Procedure.[57] At the time of writing, the Council has not yet adopted the decision.

2.3 RULE OF LAW MECHANISM

The Rule of Law Mechanism presents another political tool. Unlike the Rule of Law Framework, which applies on a case-by-case basis, this one is based on the regular annual dialogue between the EU institutions, MSs, and various relevant stakeholders with the aim of strengthening mutual cooperation, identifying threats, and providing recommendations on a systematic basis. According to the Commission, 'it focusses on improving understanding and awareness of issues and significant developments in areas with a direct bearing on the respect for the rule of law – justice system, anti-corruption framework, media pluralism and freedom, and other institutional issues linked to checks and balances'.[58] From 2020, the Commission has been providing annual rule of law reports containing specific country chapters. In these chapters, the Commission evaluates the state-of-the-art of the monitored benchmarks and compliance with the recommendations obtained in earlier reports and, if necessary, addresses the new ones. Moreover, from 2022, the Commission also provides specific country recommendations. Again, not complying with the Commission's recommendations may result in the activation of Article 7 TEU.

As regards Poland and Hungary, it could be concluded that both countries ignored the recommendations from the 2022 Rule of Law Report. In fact, Poland has not made any progress regarding the adoption of the recommended measures, while Hungary has made very limited progress.

Political tools, due to an evident lack of political will of the main players to act as well as the (mere) soft power nature of the recommendations, do not provide an effective solution to the problem of Member States backsliding from the rule of law. The cases of Hungary or Poland have clearly proven that MSs, which wilfully disregard the rule of law, have neither fear to be shamed nor to be politically sanctioned.

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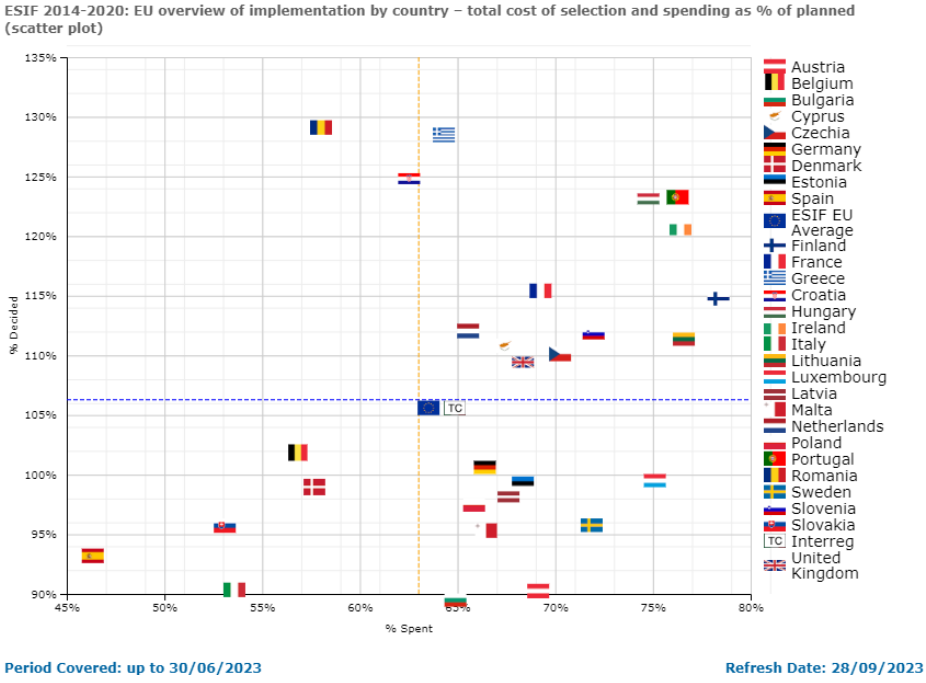
[52] Commission, 'Commission adopts Rule of Law Opinion on the situation in Poland' (Press Release) [2016] IP/16/2015.
[53] [2016] OJ L217/53.
[54] [2017] OJ L22/65.
[55] [2017] OJ L228/19.
[56] [2018] OJ L17/50.
[57] Commission, 'Reasoned proposal' (n 40).
[58] Commission, '2020 Rule of Law Report: The rule of law situation in the European Union' COM (2020) 580 final.

3 FINANCIAL TOOLS

Why can financial tools be better? Generally, a limitation or suspension of access to the financial sources proved to be a very persuasive argument in many negotiations of any kind (either public, private, national, or international). Indeed, the idea of conditionalizing money with a discipline is not new. Already in 2012, the CJEU explained that the purpose of conditionality, while withdrawing the financial assistance from EU budget, is to ensure the compliance with EU law.[59] As most of the Member States benefit from the EU budget,[60] usually through grants of the European Structural and Investment Funds (ESIF) (*Figure 2*), the EU has been trying to find a better way to conditionalize its drawing.

Figure 2: Overview of 2014-2020 ESIF implementation by MSs



Source: <https://cohesiondata.ec.europa.eu/overview/14-20> accessed 28 September 2023

Linking conditions to the budget became a more visible trend in the programming period 2014-2020. This was characterised by *ex ante* conditionalities, which included, in particular, the requirements of arrangements for an effective application of EU public procurement law, anti-discrimination law, or gender equality law.[61] As noticed by Viţăr, *ex*

[59] See Case C-370/12 *Pringle* EU:C:2012:756 para 69

[60] According to a platform Statista, net contributors to the 2021 EU budget were just Germany, France, The Netherlands, Italy, Sweden, Denmark, Austria, Finland, and Ireland. <https://www.statista.com/chart/18794/net-contributors-to-eu-budget/> accessed 17 September 2023.

[61] Annex XI, Part II of the European Parliament and Council Regulation (EU) No 1303/2013 laying down common provisions on the European Regional Development Fund, the European Social Fund, the Cohesion Fund, the European Agricultural Fund for Rural Development and the European Maritime and Fisheries Fund and laying down general provisions on the European Regional Development Fund, the European Social Fund, the Cohesion Fund and the European Maritime and Fisheries Fund and repealing Council Regulation (EC) No 1083/2006 [2013] OJ L347/320.

ante conditionalities positively stimulated MS to start 'important legislative, institutional and policy reforms in an incredibly short amount of time'.[62]

However, the good ideas of legislators collided with the requirement that the assessment of compliance with those horizontal principles should be conducted by the MS itself and only during the initial phase (when approving the strategic document and operational programs takes place). The Commission only confirmed the results of the self-assessment provided by the MS. If the Commission did not confirm the assessment due to concerns of compliance with the conditionalities, the MS was given the chance to adopt an Action Plan, which should contain the appropriate measures on how to fix it. However, not complying with the Action Plan did not in fact disqualify the MS from drawing the budget through the ESIF, as the Commission was not consistent in controlling its fulfilment. This was criticised also by the European Court of Auditors (ECA) in its 2021 Special Report.[63] ECA pointed out that the ESIF 2013 Common Provision Regulation '[d]id not require MS and Commission to monitor whether ex ante conditionalities remained fulfilled through the programme's lifetime and that is thus unclear, whether the achievements reported in this process had been sustained throughout the entire 2014-2020 period'.[64] Furthermore, 'non-fulfilment of ex ante conditionalities rarely had financial consequences'.[65]

Trying to remedy this deficiency, the EU legislators introduced, within 2021-2027 the Multiannual Financial Framework (MFF) and the Next Generation EU (NGEU) programme, three new financial instruments: the Conditionality Regulation,[66] the European structural and investment funds (ESIF) and the Resilience and Recovery Facility (RRF),[67] containing a brand-new package of conditionalities regulating the expenditures from the EU budget. Budgetary conditionalities present a toolbox for the protection of the rule of law, different to those from the political or the legal toolboxes. The former can be applied independently from them, as political and legal tools pursue different goals and are subject to different rules.[68] However, factors, such as 'strong justice systems, a robust anti-corruption framework, and clear and consistent system of law-making, the protection of the EU's financial interest, and sustainable growth',[69] are common to every tool at stake. Moreover, rule of law factors are key drivers for financial instruments which promote structural reforms in MSs. As noticed by Fisicaro, each of these financial instruments 'contributes to shape the

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[62] Viorica Viţăr, 'Research for REGI Committee – Conditionalities in Cohesion Policy' (2018) 11 <https://www.europarl.europa.eu/RegData/etudes/STUD/2018/617498/IPOL_STU(2018)617498_EN.pdf> accessed 10 December 2023.

[63] European Court of Auditors, 'Performance-Based Financing in Cohesion Policy: Worthy Ambitions, but Obstacles Remained in the 2014-2020 Period' (2022) <https://www.eca.europa.eu/en/publications?did=59899>accessed 10 December 2023.

[64] ibid 16.

[65] ibid 17.

[66] European Parliament and Council Regulation (EU, EURATOM) 2020/2092 of 16 December 2020 on a general regime of conditionality for the protection of the Union budget [2020] OJ LI433/1 (Conditionality Regulation).

[67] To see the differences between ESIF and RRF, see the comparative analysis of the ECA, available at <https://www.eca.europa.eu/Lists/ECADocuments/RW23_01/RW_RFF_and_Cohesion_funds_EN.pdf> accessed 10 December 2023.

[68] cf Case C-157/21 *Poland v Parliament and Council* (n 17) para 207; Joined cases 15 and 16/76 *France v Commission* EU:C:1979:29 para 26.

[69] Commission, '2021 Rule of Law Report: The rule of law situation in the European Union' COM (2021) 700 final.

EU budget as a more values-oriented policy instrument for the coming years'.[70] Respect for the rule of law within MSs therefore presents an inevitably horizontal conditionality.[71]

The research question in this part is focused on whether the new financial tools at the Union's disposal present the effective tools for the protection of rule of law? The case law of the CJEU relating to the application of the tools from the current financial toolbox is rather modest at the time. The author's conclusions are therefore based on her own analysis as well as on analyses by other authors.

3.1 CONDITIONALITY REGULATION

The painful process of operationalization of the Conditionality Regulation already indicated that its application would not be easy.[72] The European Council's questionable interference with the Commission's independence or the CJEU's exclusive power to interpret EU law[73]) and a lengthy process (more than a year to the adoption of guidelines[74] on the application of the Conditionality Regulation by the Commission) raise concerns on whether and how the Commission intends to use this new tool.

To raise the expectations of further Commission's action, the statement of Commissioner Hahn (responsible for the budget and administration) should be recalled:

> [W]e cannot make concessions when it comes to protecting the Union's financial interests and its founding values. With conditionality regulation, we have another tool in our toolbox, at a time when we are managing the largest EU budget in history. Where the conditions of the regulation are fulfilled, we will act with determination.[75]

Despite the ultimate effort of Poland and Hungary to sever the linkage between the rule of law and EU money, the CJEU confirmed that the rule of law 'is capable of constituting the basis of a conditionality mechanism covered by the concept of financial rules'[76] governing the establishment and implementation of a budget as well as the procedure for presenting and auditing accounts.[77] Sound financial management of the EU budget and the EU's financial interests could be compromised if a MS backslides from the rule of law, as it may result to 'no guarantee that expenditure covered by the EU budget satisfies all the financing

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[70] Marco Fisicaro, 'Beyond the Rule of Law Conditionality: Exploiting the EU Spending Power to Foster the Union's Values' (2022) 7 European Papers 697, 719.
[71] cf Case C-157/21 *Poland v Parliament and Council* (n 17) para 154.
[72] cf Petra Jeney, 'The EU Conditionality Regulation – Variations on Procrastination' (EIPA Briefing 2021/4, 2021) <https://aei.pitt.edu/103700/> accessed 10 December 2023; Laurent Pech, 'No More Excuses: The Court of Justice greenlights the rule of law conditionality mechanism' (*Verfassungsblog*, 16 February 2023) <https://verfassungsblog.de/no-more-excuses/> accessed 10 December 2023; Izabel Staudinger, 'The Rise and Fall of Rule of Law Conditionality' (2022) 7(2) European Papers 721.
[73] Conclusions from European Council meeting (10 and 11 December 2020), EUCO 22/20.
[74] Communication from the Commission - Guidelines on the application of the Regulation (EU, EURATOM) 2020/2092 on a general regime of conditionality for the protection of the Union budget [2022] OJ C123/12.
[75] Commission, 'EU budget: Commission publishes guidance on the conditionality mechanism' (Press release, 2 March 2022) <https://ec.europa.eu/commission/presscorner/detail/en/ip_22_1468> accessed 10 December 2023.
[76] Case C-157/21 *Poland v Parliament and Council* (n 17) para 146.
[77] Art 322(1)(a) TFEU.

conditions laid down by EU law and therefore meets the objectives pursued by the EU when it finances its expenditure'.[78]

However, the Conditionality Regulation 'does not apply to a generalised deficiency of the rule of law'[79] in a MS and may be used only if other, more suitable tools could not be used more effectively. However, it may 'protect the EU budget in situations where the EU's financial interest may be at risk due to generalised deficiencies of the rule of law in a MS',[80] i.e., 'in cases of breaches of the rule of law principles that affect or seriously risk affecting the sound financial management of the EU budget or the EU's financial interests in a sufficiently direct way'.[81] Therefore, if the MS implements the EU budget, respect for the rule of law is an essential prerequisite for compliance with the principles of sound financial management.[82] This is the crucial point, as 70% of the EU budget is spent under a shared management between the Commission and the MSs, with the MSs distributing funds and managing expenditures.[83]

> [S]ound financial management can only be ensured by MSs if public authorities act in accordance with the law, if cases of fraud, including tax fraud, tax evasion, corruption, conflict of interest or other breaches of the law are effectively pursued by investigative and prosecution authorities, and if arbitrary or unlawful decisions of public authorities, including law-enforcement authorities, can be subject to effective judicial review by independent courts and by the CJEU.[84]

Under the Conditionality Regulation, a MS, which backslides with the sound financial management of the EU budget by not respecting the rule of law and other fundamental values enshrined in Article 2 TEU, can face the consequences in the form of suspension, reduction, or interruption of payments or budgetary commitments, while its obligation to fulfil financial commitments towards final beneficiaries remains preserved. Any assessment in this regard requires a thorough double consideration (firstly by the Commission and later by the Council) on whether (i) a breach of the rule of law exists, (ii) whether such a breach affects or seriously risks affecting the sound financial management of the EU budget or the EU financial interests in a sufficiently direct way, (iii) whether more suitable measures are not available to protect the EU budget more effectively (negative confirmation is required), and (iv) whether the measure to be taken is proportionate and adequate to remedy the identified deficiency.

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[78] Case C-157/21 *Poland v Parliament and Council* (n 17) para 149.
[79] European Parliament, 'Economic and Budgetary Outlook for the European Union 2023' [2023] <https://www.europarl.europa.eu/RegData/etudes/STUD/2023/739313/EPRS_STU(2023)739313_EN.pdf> accessed 17 September 2023.
[80] Commission, '2020 Rule of Law Report' (n 58) 26.
[81] European Parliament, 'The Tools for Protecting the EU Budget from Breaches of the Rule of Law: The Conditionality Regulation in Context' (2023) accessed 28 September 2023.
[82] Conditionality Regulation (n 66) preamble recital 7.
[83] European Parliament, 'Implementation of the budget' (*Fact Sheets of the European Union*, 2023) <https://www.europarl.europa.eu/factsheets/en/sheet/30/implementation-of-the-budget> accessed 10 December 2023. To the explanation on how the shared financial management see, for example, Viorica Viţăr, 'Mainstreaming Equality in European Structural and Investment Funds: Introducing the Novel Conditionality Approach of the 2014-2020 Financial Framework' (2017) 18(4) German Law Journal 993, 997.
[84] Conditionality Regulation (n 66) preamble recital 8

The new tool has already been tested and applied in Hungary. Since 2018, Hungary has been facing the procedure under Article 7(1) TEU[85] and the Commission in its annual Rule of Law Report 2022, 2023 repeatedly declared that the improvement regarding the rule of law was not sufficient. Nevertheless, it took 24 months for the Council, upon a Commission's proposal, to adopt a decision[86] on the suspension of 55% of the budgetary commitments (i.e. approximately €6.3 billion) in the three programs of Cohesion Policies. In this decision, the Council forbids the Commission, when implementing the EU budget in direct or indirect management, to enter into legal commitments with any public interest trust established on the basis of the Hungarian Act XI of 2021 or any entity maintained by such a public interest trust. Concerns were related to the public procurement, the effectiveness of prosecutorial action, and the fight against the corruption.[87] As information on the implementation of sufficient remedial measures by Hungary, as well as a Commission proposal on lifting the adopted financial measure are not yet available, it can be concluded that, within 10 months of its application, financial tools were not effective enough to persuade Hungary to respect the rule of law. However, Hungary still has some time left for solving the situation of being sanctioned (suspensions of commitments in implementing decision are just of a 'temporary nature and can be lifted without loss of Union funding) if the situation is fully remedied within two years'.[88]

Poland is in a similar situation as Hungary regarding the rule of law. However, the Commission has not triggered a financial conditionality mechanism against Poland, yet. The fact that the Commission, in its Annex to the 2023 Rule of Law Report,[89] clearly stated 'no progress' on any of the recommendations formulated in the report from 2022, seems to be irrelevant.

In this regard, Hoxhaj points out that such a benevolent approach of the Commission can be caused by Russia's invasion of Ukraine and that the rule of law compliance was outperformed by the political need to reach consensus in the Council regarding the voting on sanctions against Russia or by other factors relating to providing support for Ukraine.[90]

Similarly to Poland and Hungary, the Commission stated in its 2022, 2023 Rule of Law reports 'no progress' relating to anti-corruption specific recommendations also in Bulgaria, Czechia, Spain, and Austria. However, any determined action regarding the application of relevant measures under the Conditionality Regulation, as announced by Commissioner Hahn, has been adopted yet. In this regard, one might wonder whether there really is equal treatment of the Member States, and whether, by failing to act, the Commission did not breach its duties as guardian of the treaties? Affirmative answers to these questions could

[85] Cf n 51.
[86] Council implementing decision (EU) 2022/2506 of 15 December 2022 on measures for the protection of the Union budget against breaches of the principle of rule of law in Hungary [2022] OJ L325/94.
[87] Council of the EU, 'Rule of law conditionality mechanism: Council decides to suspend €6.3 billion given only partial remedial action by Hungary' (Press release, 12 December 2020) < https://www.consilium.europa.eu/en/press/press-releases/2022/12/12/rule-of-law-conditionality-mechanism/> accessed 10 December 2023.
[88] ibid.
[89] Commission, '2023 Rule of Law Report: The rule of law situation in the European Union' COM (2023) 800 final.
[90] Andi Hoxhaj, 'The CJEU Validates in C-156/21 and C-157/21 the Rule of Law Conditionality Regulation Regime to Protect the EU Budget' (2022) 5 Nordic Journal of European Law 131, 143.

raise doubts, whether the rule of law, the value on which the EU is established, is not jeopardized by the EU institutions themselves.

3.2 ESIF ENABLING CONDITIONALITIES

The ESIF presents the traditional financial tool through which, by receiving grants, MSs achieve cohesion goals. The 2021 Common Provision Regulation[91] complements the enabling conditionality mechanism established by the Conditionality Regulation. It follows up on the conditionalities introduced in the programming period 2014-2020 (gender equality, non-discrimination, sustainable development including climate change mitigation), improves them, and introduces a new one – respect for fundamental rights and compliance with the Charter of Fundamental Rights of the European Union (Charter) while implementing EU Funds.[92]

These horizontally enabling conditions can impose an interruption[93] (up to six months) of the payment deadline or suspension of all or part payments[94] and shall impose financial corrections by reducing support from ESIF[95] on the MS, if it does not comply with the applicable law and does not protect the financial interests of the EU, when it implements EU budget under the shared management. Improvements, compared to the previous Common Provision Regulation [2013] could be seen particularly in the formulation of Charter-related conditionality, which shall apply during all phases of the ESIF implementation and relates not only to the preparatory phase.

New ESIF enabling conditions were already being applied against Hungary. In December 2022, the Commission considered that Hungary was not fulfilling the horizontal enabling condition of the Charter, as Hungarian legislation on 'child-protection law, and the serious risks to academic freedom and right to asylum have a concrete and direct impact on the compliance with the Charter in the implementation of certain specific objectives of the three cohesion programmes and of the Asylum Migration and Integration Fund respectively'.[96] This resulted in the Commission's duty not to reimburse the related expenditures, with a reservation to technical assistance and those expenditures, which leads to fulfilling the enabling conditions. Again, information whether Hungary has remedied the identified deficiencies, remains unavailable.

One might also recall the Polish case of creating 'LGBT ideology-free zones' in 2019. The Commission even started an infringement procedure in this regard,[97] however, not due to the breach of the principle of non-discrimination and equal treatment, but due to the

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[91] European Parliament and Council Regulation (EU) 2021/1060 of 24 June 2021 laying down common provisions on the European Regional Development Fund, the European Social Fund Plus, the Cohesion Fund, the Just Transition Fund and the European Maritime, Fisheries and Aquaculture Fund and financial rules for those and for the Asylum, Migration and Integration Fund, the Internal Security Fund and the Instrument for Financial Support for Border Management and Visa Policy [2021] OJ L231/159.
[92] ibid Art 9.
[93] ibid Art 96.
[94] ibid Art 97.
[95] ibid Art 104.
[96] Commission, 'EU Cohesion Policy 2021-2027: Investing in a fair climate and digital transition while strengthening Hungary's administrative capacity, transparency and prevention of corruption' (Press release, 22 December 2022) <https://ec.europa.eu/commission/presscorner/detail/en/ip_22_7801> accessed 10 December 2023.
[97] No. INFR(2021)2115.

breach of the principle of sincere cooperation stipulated in Article 4(3) TEU, as the 'Polish authorities have failed to provide the requested information, manifestly omitting to answer most of the Commission's requests'[98] relating to their investigation regarding the nature and impact of the resolutions of 'LGBT-ideology free zones' adopted by several Polish regions and municipalities. The case is no longer active. Despite the EP's call for the Commission to monitor the use of ESIF and to take measures to 'address clear and direct breaches of anti-discrimination rules',[99] and published second-hand information on the Commission's intention to suspend ESIF financing until enabling conditionality on Charter will be fulfilled by Poland,[100] no relevant measures adopted by the Commission in this regard have been officially published so far.

Relevant conclusions on whether this tool works effectively could therefore not be adopted yet. However, as pointed out by Łacny, the problem might be 'not the lack of adequate legal tools, but the lack of political will on the part of the Commission to use the tools that already exist'.[101]

3.3 RECOVERY AND RESILIENCE FACILITY

The Recovery and Resilience Facility (RRF) is an important part of the NGEU programme, which was set up to mitigate the socio-economic impact of the Covid-19 pandemic. The RRF, which was introduced by RRF Regulation,[102] is the mechanism within the NGEU programme, under which MSs can apply for grants and loans. The RRF runs concurrently with the ESIF. As explained by the ECA,

> [t]his allows MSs to choose to finance investments using either the RRF or the ESIF. The RRF is implemented under direct management, while cohesion policy funds are implemented under shared management. This means that EU and MS authorities have different responsibilities in connection with each source of funding. Regardless of the management mode, the Commission is ultimately responsible for implementing the EU budget. The multi-level governance structure and the partnership principle applicable to cohesion policy funds do not apply to the RRF.[103]

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[98] Commission, 'EU founding values: Commission starts legal action against Hungary and Poland for violations of fundamental rights of LGBTIQ people' (Press release, 15 July 2021) <https://ec.europa.eu/commission/presscorner/detail/en/ip_21_3668> accessed 10 December 2023.
[99] European Parliament, 'Public discrimination and hate speech against LGBTI people, including LGBTI free zones' (Resolution) [2019] P9_Ta (2019) 0101.
[100] Alexandra Krysztoszek, 'Polish LGBT-Free Zones Won't Get EU Funding, Says French MEP' (*EURACTIV*, 18 May 2023) <https://www.euractiv.com/section/politics/news/polish-lgbt-free-zones-wont-get-eu-funding-says-french-mep/> accessed 10 December 2023.
[101] Justyna Łacny, 'Suspension of EU Funds Paid to Member States Breaching the Rule of Law: Is the Commission's Proposal Legal?' in Armin von Bogdandy et al, *Defending Checks and Balances in EU Member States: Taking Stock of Europe's Actions* (Springer Link 2021).
[102] European Parliament and Council Regulation (EU) 2021/241 establishing the Recovery and Resilience Facility [2021] OJ L57/17 (RRF Regulation).
[103] European Court of Auditors, 'EU Financing through Cohesion Policy and the Recovery and Resilience Facility: A Comparative Analysis' (2023) 6 <https://www.eca.europa.eu/en/publications/RW23_01> accessed 10 December 2023.

By its nature, the RRF is a temporary tool dedicated to strengthen MSs in the key six pillars pursued by the EU: green transition; digital transformation; smart, sustainable and inclusive growth; social and territorial cohesion; health, economic, social and institutional resilience; and policies for the next generation, children and the youth, such as education and skills.[104] A MS is eligible to receive grants from RRF upon the basis of the Recovery and Resilience Plan (RRP), which must include a detailed plan, explanation and milestones, on how it will contribute to these six pillars; effectively address challenges identified in the relevant country-specific recommendations; how it strengthens the growth potential, job creation and economic, social and institutional resilience of the MS concerned; how it contributes to addressing energy poverty; how the principle of do-not-harm will be applied; and whether it comprises cross-border or multi-country projects.[105] The crucial point is that, even if the MS obtains a Council implementing decision on the approval of the assessment of the recovery and resilience plan, the release of funds is conditional to satisfactory fulfilment of the relevant milestones and targets defined in its RRP.

Regarding our topic, especially the pillar on economic and institutional resilience provides a sufficient place to require adopting relevant measures and reforms to comply with the rule of law. Hungary might serve as an example again. In December 2022, the Council approved its RRP,[106] however, it has also defined a number of enabling conditions including those which relate to the rule of law (for instance, the setting up of an Anti-Corruption Task Force, due implementation of National Anti-Corruption strategy and action plan, measures on strengthening the judicial independence, measures to increase the competition in public procurement, among others).

The performance-based nature of the RRF can then guarantee that funds are disbursed when qualitative (achievement of milestones) and quantitative (achievement of targets) implementation steps will be realised. By November 2023, zero-performance (i.e., any of the milestones and targets were achieved) showed Belgium, Finland, Germany, Hungary, Ireland, and Poland.[107] Despite this, Belgium, Finland and Germany have already disbursed RRF grants.[108] This leads to the conclusion that the performance-based approach to the RRF has the potential to be an effective tool to protect the rule of law. At the same time, concern remain on how the Commission ensures the rule of law and protects the EU budget.

4 CONCLUSION

Does the EU provide effective tools to ensure respect for preserving the rule of law? The answer to this question is not as easy as to say yes or no. It is clear that the EU focus is on prevention rather than to take action against the MS backsliding on the rule of law.

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[104] RRF Regulation (n 102) Art 3.
[105] ibid Art 18(1).
[106] Council implementing decision on the approval of the assessment of the recovery and resilience plan for Hungary 1544/22 [2022] 0414 (NLE).
[107] Commission, 'Recovery and Resilience Scoreboard – Milestones and Targets' <https://ec.europa.eu/economy_finance/recovery-and-resilience-scoreboard/milestones_and_targets.html?lang=en> accessed 2 October 2023.
[108] Commission, 'Recovery and Resilience Scoreboard – Disbursements' <https://ec.europa.eu/economy_finance/recovery-and-resilience-scoreboard/disbursements.html?lang=en> accessed 23 November 2023.

The aim of the article was to verify a number of hypotheses on the effectiveness of a particular set of tools, which aim to ensure compliance with the rule of law. Poland and Hungary were used as case-studies to test the capacity of the EU and its political willingness to react to threats and breaches of its own founding values by a MS.

Analysis shows that whenever the application of enforcement tools is left only to the Commission, it seems that political factors outweigh the legal ones. Moreover, the Commission is not keen to go into direct confrontation with the MS concerned.

Poland and Hungary have begun to backslide on the rule of law in 2015. However, after eight years, the Commission was not able to ease the problem. In fact, the situation has worsened.

Infringement proceedings, due to their length, and the apparent Polish and Hungarian disregard to the final judgments on infringements, proved to be an ineffective tool in protecting the rule of law.

A lack of political will to invoke Article 7 TEU (not just on the part of the Commission) paralysed this tool and deprived it from any deterrent effect. Neither soft political tools, such as the Rule of Law Framework, nor the Rule of Law Mechanism have successfully deterred Poland and Hungary from disrespecting EU values. The first hypothesis is therefore considered to be verified.

Likewise, financial tools have not yet proved their potential. However, given the recent application of conditionality in Hungary, there is still some time for MSs to adopt the relevant conclusions in this matter. A great expectation is given to the RRF due to its innovation in the form of performance-based assessment towards the conditionalities, which is rather neutralised with the finding that some MSs were allowed to RRF grants despite not fulfilling the milestones. A solid toolbox of financial measures, which have the potential to ensure a comeback onto the path towards fundamental EU values is therefore relativized by its user. The second hypothesis could therefore not be verified at the moment.

However, the desired effect could be reached if the political and financial system discussed, as well as the legal proceedings under Articles 258-260 TFEU, are applied in tandem. It is upon the Commission to stand to its word and guard the treaties with due care.

The final conclusion is that the EU institutions must not undermine the perception of the rule of law by weak enforcement (if not un-enforcement), undue delays in procedures and unequal treatment of Member States. Precisely such (in)action by the EU may have contributed to such developments as can be seen in Poland and Hungary.

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IMPLEMENTING DECISIONS ON ENVIRONMENTAL CONFLICTS BEYOND THE NATION STATE

A CONCEPT STRUCTURAL OUTLINE

ANDREAS CORCACI*

This article theorises the national implementation of European and international decisions on environmental conflicts, integrating both judgments from courts and so-called managerial decisions from (non-)compliance mechanisms in multilateral environmental agreements. Starting from the observation that the impact of climate change is increasing with backlash from populist governments and political regimes against its mitigation, implementing legal obligations in the absence of specialised environmental courts is crucial to protect the environment from harm. However, systematic insights on the national implementation of judgments and managerial decisions made beyond the nation state are underexplored. Following a political science perspective, this article conceptualises the conditions explaining this phenomenon by making use of existing research from various disciplines including political science and law on policy implementation to enable systematic comparisons. For this purpose, the article outlines a concept structural approach based on two hypothesised explanations: one based on the mechanisms used to solve conflicts, and another relating to the legitimacy of relevant institutions and processes of conflict resolution. These explanatory pathways reflect the existing management and enforcement approaches from the political science literature on implementation and follow a conjunctural logic. The theoretical approach developed in this article enables systematic comparisons across decisions and thus accounts for a variety of separate but equally valid explanations. Future research and empirical analysis will directly feed back into the concept structure for further theoretical development and lead to generalisable insights on the national implementation of court judgments and managerial decisions on environmental conflicts. In this way, the aim is to contribute to both political science and legal literature regarding European and international environmental law, environmental politics, and judicial governance.

1 INTRODUCTION

The protection of Earth's environment is a global undertaking not confined to the borders of nation states. Damage to nature and people alike due to hazardous waste from industrial production or environmental disasters, but also the impact of industrial activity on the quality of drinking water and air can result in conflicts that reach across territorial levels of governance. Such conflicts are resolved beyond the nation state, but they require national implementation. For example, the European Court of Justice (CJEU) has established

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extensive case law on the protection of ambient air in the European Union (EU) based on Directive 2008/50, without which the directive would have not been implemented comprehensively in the Member States.[1] Against the background of the increasing impact of climate change and a lack of specialised jurisdiction over supra- and international environmental conflicts, implementing environmental legal obligations is therefore a crucial tool to protect the environment.

The research puzzle resulting from this observation is that implementation of such obligations occurs despite resting on distinct types of what is called 'resolution mechanisms' hereafter – an umbrella term containing court judgments and managerial decisions from non-compliance mechanisms (NCMs).[2] Following a political science perspective, this article makes theoretical and conceptual contributions to both political science and legal literature by developing an analytical framework that enables empirical comparisons of national implementation processes of European and international court judgments and managerial decisions on environmental conflicts.[3] In this context, it focuses on conceptualising *macro-level conditions* for effective national implementation. Different from legal analysis, the article is aimed at enabling broad empirical comparisons across resolution mechanisms and integrating judgments and other decisions at EU level and internationally. While decisions in the context of EU law carry a different weight for Member States than international law for consenting states, the macro-level approach in this article aims at identifying general conditions for effective implementation valid across different arenas. Insights from this work are relevant for legal researchers because it provides an innovative framework for systematic empirical comparisons across different types of resolution mechanisms and on different governance levels. This can feed into legal research by facilitating a different and critical perspective on environmental conflicts, thus offering new ideas and inspiration enabling further detailed legal doctrinal analysis of specific judgments and decisions. The article addresses the following research question from a political science perspective: *How can the effective national implementation of European and international judgments from courts and managerial decisions from non-compliance mechanisms on environmental conflicts be theorised to enable comparisons across resolution mechanisms?*

To answer this question, a novel research design is developed based on the idea of *concept structures*,[4] a formalised methodology of concept building in the social sciences that uses formal logic and indirectly set theory to specify concepts and conceptual and empirical relationships within research designs. Concept structures provide a strong connection

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[1] Delphine Misonne, 'The emergence of a right to clean air: Transforming European Union law through litigation and citizen science' (2020) 30(1) Review of European, Comparative & International Environmental Law 34.

[2] While this article is written from a political science perspective, the terminology is used in different ways depending on discipline, which is why terms building on both political science and legal literature have been developed that are used consistently throughout the article (see *Table 1*).

[3] Although the terms 'dispute' and 'conflict' are broad and often used to describe a wide range of phenomena including private disputes, the focus of this research is on the context of European and international courts, tribunals, and multilateral agreements.

[4] Gary Goertz, *Social Science Concepts. A User's Guide* (Princeton University Press 2006); Gary Goertz, *Social Science Concepts and Measurements. New and Completely Revised Edition* (Princeton University Press 2020); see also Andreas Corcaci, *Compliance in der Europäischen Union. Mengentheoretische Konzeptformation und logische Formalisierung anhand einer QCA qualitativer Fallstudien* (Studien zur Europäischen Union Vol. 10, ed Wolfgang Wessels, Springer VS 2019).

between theoretical foundations, methodology, and empirical analysis. The resulting framework is developed with three distinct aims: (1) to establish a conceptual and analytical basis for comparisons; (2) to theorise the conditions for effective implementation of judgments and managerial decisions against the background of different actor preferences, in particular the perceived legitimacy of institutions and processes, and the type of resolution mechanism; (3) as a basis for empirical analysis based on set theoretic multimethod research (SMMR),[5] especially a configurational assessment of medium case numbers and subsequent process tracing of unexpected cases.

In section 2, the implementation of European and international judgments and managerial decisions on environmental conflicts is theorised. A literature overview is provided to put the research into context and connect different strands of literature to the concepts and conditions at hand, focusing on political science as well as legal contributions when relevant to the research context. Section 3 starts from existing research on implementation in the EU[6] to discuss resolution mechanisms and their legitimacy in more detail as core conditions. While the article also makes use of legal research to illustrate the relevance of these conditions from perspectives outside of political science, this section explicitly does not aim at a systematic doctrinal analysis of relevant legal cases. Two hypotheses based on these conditions are derived from the management and enforcement approaches,[7] which serve as the theoretical foundation for this article. Next, the concept structural foundations of implementation are elaborated as a research methodology, resulting in the development and discussion of the formalised concept structure. The article concludes by describing the implications for empirical analysis. The article advances research on environmental conflict resolution by outlining a concept structural approach to effective implementation of court judgments and managerial decisions. This research also feeds into other disciplines by enabling empirical comparisons across resolution mechanisms and governance levels, thus facilitating a different way to think critically about European and international decisions from a multilevel perspective.

2 CONTEXTUALISING ENVIRONMENTAL CONFLICT RESOLUTION

2.1 RESEARCH CONTEXT

To account for different disciplinary perspectives relevant to this article, this section references literature from various strands of political science research as well as legal

[5] *Set theoretic multimethod research* describes the combination of two empirical research methods, namely Qualitative Comparative Analysis (QCA), a case-based method based on set theory and formal logic, and qualitative case studies; see Gary Goertz and James Mahoney, *A Tale of Two Cultures. Qualitative and Quantitative Research in the Social Sciences* (Princeton University Press); Carsten Q Schneider and Ingo Rohlfing, 'Set-Theoretic Multimethod Research: The Role of Test Corridors and Conjunctions for Case Selection' (2019) 25(3) Swiss Political Science Review 253.

[6] Andreas Corcaci, 'Conceptual considerations on compliance in the European Union' in Roland Lhotta, Oliver W Lembcke, and Verena Frick (eds), *Politik und Recht: Umrisse eines politikwissenschaftlichen Forschungsfeldes* (Nomos Verlagsgesellschaft 2017); Corcaci, *Compliance in der EU* (n 4).

[7] Jonas Tallberg, 'Paths to Compliance: Enforcement, Management, and the European Union' (2002) 56(3) International Organization 609.

contributions relevant to the article's concepts and conditions. Additionally, an integrated trans-disciplinary terminology is being proposed (see *Table 1*).

Table 1: Integrated research terminology

Term	Meaning
Court judgment	Judgment of a European or international court or tribunal, legally binding
Managerial decision	Result/outcome of a non-compliance mechanism or procedure in multilateral environmental agreements, cooperative and not confrontational/punitive
Non-compliance mechanism	Non-confrontational, managerial procedure designed to address compliance issues, usually operated within multilateral environmental agreements
Resolution mechanisms	Umbrella term describing different procedures to resolve implementation issues: judgments from courts and managerial decisions from non-compliance mechanisms
Implementation (of a legal act)	Overarching process of putting a legal obligation into effect, conceptually includes transposition of a European or international legal act into national law, establishment of administrative structures and procedures, and practical application of the legal act
Transposition (of a legal act)	Incorporation of a European or international legal obligation into national law
Administration (of a legal act)	Establishment of administrative structures and/or processes required to apply a transposed legal act in practice
Application (of a legal act)	Practical operation of a legal obligation (as opposed to mere formal transposition without practical application)

Source: author's illustration

Research on the implementation of environmental policy and law and especially the transposition of directives in the EU has made significant progress since the 1990s. However, systematic insights into the implementation of court judgments and managerial decisions on environmental conflicts beyond the nation state are lacking, as is generalisable knowledge valid across different types of resolution mechanisms. The article will address this limitation in the literature starting from the observation that compliance with international obligations 'requires nuanced measures which can be adapted to different conditions and changing circumstances'[8] and takes place under various structural, procedural, and context conditions that concern different levels of governance.[9] National legal frameworks are often dense, whereas European law implies its own unique implementation setting[10] and the

[8] Edith Brown Weiss, 'Understanding Compliance with International Environmental Agreements: The Baker's Dozen Myths' (1998) 32(5) University of Richmond Law Review 1555, 1589.
[9] For an overview, see Oliver Treib, 'Implementing and complying with EU governance outputs' (2014) 9(1) Living Reviews in European Governance.
[10] Corcaci, 'Conceptual considerations' (n 6).

Europeanisation of (sub-)national institutions.[11] Both national and the European court systems are integrated and institutionalised,[12] while EU governance can be characterised as judicialized.[13] In contrast, the implementation of international legal obligations is complex due to the sovereignty of contracting states[14] and the resulting differences between European and international levels.[15] Even more so, the underlying multilevel nature implies complex compliance dynamics between the international, European, and national levels, with uncertainty and problems arising because of the discretion that international and European law leaves to the implementing nation states.[16] This in turn can cause challenges for international courts and the states concerned in using various resolution mechanisms for effectively enforcing, managing, and sanctioning infringements.[17]

Effective enforcement goes hand in hand with how nation states perceive the institutional and procedural legitimacy of international courts, tribunals, and multilateral agreements.[18] Additional complexity arises because international environmental law and policy[19] are often tied to the international diplomacy of climate change. This also applies to International Courts and Tribunals (ICTs) the more they engage with the environment.[20] Finally, the proliferation of environmental courts and tribunals (ECTs)[21] at the regional and national levels has not spilled over to the European and international arenas, where no

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11 Peter Bursens, 'Europeanization and Sub-National Authorities' in Simon Bulmer and Christian Lequesne (eds), *The Member States of the European Union* (Oxford University Press 2020).

12 Rachel A Cichowski, 'Overview of institutionalization in the European Union' in Rachel A Cichowski, *The European Court and Civil Society: Litigation, Mobilization and Governance* (Cambridge University Press 2007).

13 Alec Stone Sweet, 'The European Court of Justice and the judicialization of EU governance' (2019) 5(2) Living Reviews in European Governance.

14 Karen J Alter, Laurence R Helfer, and Mikael R Madsen, *International Court Authority* (Oxford University Press 2018).

15 Katja S Ziegler, 'The Relationship between EU Law and International Law' in Dennis Patterson and Anna Södersten (eds), *A Companion to European Union Law and International Law* (Wiley Blackwell 2016).

16 Corcaci, *Compliance in der EU* (n 4); Andreas Corcaci, 'The Dynamics of multilevel administration. Empirical insights from national, supra- and international administrations in energy policy' (2022) Zeitschrift für Politikwissenschaft/Journal of Political Science.

17 For courts: Andreas Føllesdal and Geir Ulfstein (eds), *The Judicialization of International Law - a Mixed Blessing?* (Oxford University Press 2018); for MEAs: Anna Huggins, *Multilateral Environmental Agreements and Compliance. The Benefits of Administrative Procedures* (Routledge 2018).

18 Andreas Føllesdal, 'Survey Article: The Legitimacy of International Courts' (2020) 28(4) The Journal of Political Philosophy 476; Christopher Lord, Peter Bursens, Dirk De Bièvre, Jarle Trondal, and Ramses A Wessel (eds), *The Politics of Legitimation in the European Union. Legitimacy Recovered?* (Routledge 2022).

19 David Hunter, James Salzman, and Durwood Zelke, *International Environmental Law and Policy* (6th edn, Foundation Press 2022); Lavanya Rajamani and Jacqueline Peel (eds), *The Oxford Handbook of International Environmental Law* (2nd edn, Oxford University Press 2021); Thomas J Schoenbaum and Michael K Young, *International Environmental Law and Policy. Cases, Materials, and Problems* (3rd edn, Carolina Academic Press 2018); Erika Techera, Jade Lindley, Karen N Scott, and Anastasia Telesetsky (eds), *Routledge Handbook of International Environmental Law* (2nd edn, Routledge 2020).

20 Stuart Bruce, 'The Project for an International Environmental Court' in Christian Tomuschat, Riccardio Pisillo Mazzeschi, and Daniel Thürer (eds), *Conciliation in International Law. The OSCE Court of Conciliation and Arbitration* (Brill Nijhoff 2017); Edgardo Sobenes, Sarah Mead, and Benjamin Samson (eds), *The Environment Through the Lens of International Courts and Tribunals* (T.M.C. Asser Press 2022); Tim Stephens, *International courts and environmental protection* (Cambridge University Press 2009).

21 Brian J Preston, 'Characteristics of Successful Environmental Courts and Tribunals' (2014) 26(3) Journal of Environmental Law 365; Don C Smith, 'Environmental courts and tribunals: changing environmental and natural resources law around the globe' (2018) 36(2) Journal of Energy & Natural Resources Law 137; Ceri Warnock, 'Reconceptualising specialist environment courts and tribunals' (2017) 37(3) Legal Studies 391.

specialised court exists despite a multitude of legal documents[22] and calls for an International Environmental Court[23] including by the ICE Coalition.[24] Environmental conflicts are therefore addressed in general courts like the CJEU and the International Court of Justice (ICJ); environmental contexts like the ITLOS and multilateral agreements, for example the Basel and Rotterdam Conventions on hazardous waste and chemicals; but also courts and tribunals in trade, investment, and human rights where environmental issues play an increasing role, like the European Court of Human Rights (ECtHR) or the World Trade Organization (WTO).

2.2 POLICY IMPLEMENTATION IN THE EU

Insights from earlier work on the implementation of EU environmental and social policy[25] and other recent contributions in this field serve as a starting point for this article. Political science research in this area has shifted focus from mere legal transposition to opening the 'black box' of implementation and 'differentiated implementation'.[26] This approach is derived from the idea of differentiated integration[27] and seeks to understand differences in the practice of implementation processes and outcomes.[28] Studies in this context assess 'gold plating',[29] practical performance of implementation,[30] and how customised domestic

[22] David Hunter, James Salzman, and Durwood Zelke, *International Environmental Law and Policy. Treaty Supplement* (2022 edn, Foundation Press 2022); Philippe Sands and Paolo Galizzi, *Documents in International Environmental Law* (Cambridge University Press 2004); Thomas J. Schoenbaum and Michael K Young, *International Environmental Law and Policy. Cases, Materials, and Problems. Document Supplement* (3rd edn, Carolina Academic Press 2018).

[23] Alessandra Lehmen, 'The Case for the Creation of an International Environmental Court: Non-State Actors and International Environmental Dispute Resolution' (2015) 16(2) Colorado Natural Resources, Energy & Environmental Law Review 179; Ole W Pedersen, 'An International Environmental Court and International Legalism' (2012) 24(3) Journal of Environmental Law 547; George W Pring and Catherine Pring, *Greening Justice: Creating and Improving Environmental Courts and Tribunals* (The Access Initiative 2009); George W Pring and Catherine Pring, *Environmental Courts & Tribunals. A Guide for Policy Makers* (UN Environment 2016); Alexandr M. Solntsev, 'The International Environmental Court – A Necessary Institution for Sustainable Planetary Governance in the Anthropocene' in Michelle Lim (ed), *Charting Environmental Law Futures in the Anthropocene* (Springer 2019).

[24] ICE Coalition <https://www.icecoalition.org> accessed 10 December 2023.

[25] Corcaci, 'Conceptual considerations' (n 6); Corcaci, *Compliance in der EU* (n 4).

[26] Simon Fink and Eva Ruffing, 'The Differentiated Implementation of European Participation Rules in Energy Infrastructure Planning: Why Does the German Participation Regime Exceed European Requirements?' (2017) 3(2) European Policy Analysis 274.

[27] Hellen Wallace, 'Differentiated integration' in Desmond Dinan (ed), *Encyclopedia of the European Union* (Lynne Rienner 2000); Dirk Leuffen, Berthold Rittberger, and Frank Schimmelfennig, *Integration and Differentiation in the European Union. Theory and Policies* (Palgrave Macmillan 2022).

[28] See already Gerda Falkner, Oliver Treib, Miriam Hartlapp, and Simone Leiber, *Complying with Europe: EU Harmonisation and Soft Law in the Member States* (Cambridge University Press 2005); Esther Versluis, 'Even Rules, Uneven Practices: Opening the "black box" of EU law in action' (2007) 30(1) West European Politics 50.

[29] Jan H Jans, Lorenzo Squintani, Alexandra Aragão, Richard Macrory, and Bernhard W Wegener, '"Gold plating" of European Environmental Measures?' (2009) 6(4) Journal of European Environmental & Planning Law 417.

[30] Asya Zhelyazkova, Cansarp Kaya, and Reini Schrama, 'Decoupling practical and legal compliance: Analysis of member states' implementation of EU policy' (2016) 55(4) European Journal of Political Research 827; Elena Bondarouk and Ellen Mastenbroek, 'Reconsidering EU Compliance: Implementation performance in the field of environmental policy' (2018) 28(1) Environmental Policy and Governance 15.

approaches (for example, rule density and requirement strictness)[31] influence practical application.[32] Similarly, other studies assess local implementation performance through political and managerial approaches[33] or analyse the involvement of supranational actors, such as agencies and the Commission in the implementation of EU laws.[34] More broadly, the article also draws on basic insights from judicial politics and governance,[35] legal studies on environmental adjudication[36] and dispute prevention[37].

This article builds on such perspectives by extracting related factors from the political science literature and subsequently deriving six macro-level conditions that account for effective implementation:

- favourable attitudes of relevant actors, especially the government in charge;
- favourable political, legal, administrative traditions, including legitimacy of institutions;
- compatible institutions, especially relevant structures in the policy field;
- compatible capacities, especially relevant administrative-regulatory capacities;
- compatible policies, especially characteristics of the legal act at hand;
- extensive enforcement, especially the possibility of issuing enforceable fines.

The political science literature on compliance with and implementation of international arrangements[38] and especially in the EU[39] illustrates that a multitude of factors can be relevant for implementing legal acts nationally. It is argued here that the national transposition and application of environmental directives in the EU can be explained through various configurations of six macro-level conditions, each an aggregate consisting of

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31 Zhelyazkova and Thomann empirically show that implementing more rules nationally than required by EU directives (quantitative customisation) reduces practical compliance with EU law, while using stricter requirements and more stringent regulations than prescribed in EU directives (qualitative customisation) improves practical compliance. Asya Zhelyazkova and Eva Thomann, '"I did it my way": customisation and practical compliance with EU policies' (2021) 29(3) Journal of European Public Policy 427, 427-28.

32 Zhelyazkova and Thomann (n 31).

33 Elena Bondarouk, Duncan Liefferink, and Ellen Mastenbroek, 'Politics or management? Analysing differences in local implementation performance of the EU Ambient Air Quality directive' (2020) 40(3) Journal of Public Policy 449.

34 Marta Migliorati, 'Where does implementation lie? Assessing the determinants of delegation and discretion in post-Maastricht European Union' (2021) 41(3) Journal of Public Policy 489.

35 Lisa J Conant, *Justice contained. Law and Politics in the European Union* (Cornell University Press 2002); Patricia Popelier, Monika Glavina, Federica Baldan, and Esther Van Zimmeren, 'A research agenda for trust and distrust in a multilevel judicial system' (2022) 29(3) Maastricht Journal of European and Comparative Law 351; Smith (n 21).

36 Antonio Cardesa-Salzmann, 'Reflections on International Environmental Adjudication: International Adjudication Versus Compliance Mechanisms in Multilateral Environmental Agreements' in Edgardo Sobenes, Sarah Mead, and Benjamin Samson (eds) *The Environment Through the Lens of International Courts and Tribunals* (T.M.C. Asser Press 2022); Emma Lees and Ole W Pedersen, *Environmental Adjudication* (Hart Publishing 2020); Ceri Warnock and Ole W Pedersen, 'Environmental Adjudication: Mapping the Spectrum and Identifying the Fulcrum' (2017) N°4/2017 Public Law 643.

37 Natalie Klein and Danielle Kroon, 'Settlement of international environmental law disputes' in Malgosia Fitzmaurice, Marcel Brus, and Panos Merkouris (eds), *Research Handbook on International Environmental Law* (2nd edn, Edward Elgar 2021); Gerhard Loibl, *Dispute Avoidance and Dispute Settlement in International Environmental Law – Some Reflections on Recent Developments* (Organisation of American States, XXIV Curso de Derecho Internacional 1997); Philippe Sands, Jacqueline Peel, Adriana Fabra, and Ruth MacKenzie, 'Compliance: implementation, enforcement, dispute settlement' in Philippe Sands, Jacqueline Peel, Adriana Fabra, and Ruth MacKenzie (eds), *Principles of International Environmental Law* (Cambridge University Press 2018).

38 Corcaci, *Compliance in der EU* (n 4) 17-22.

39 ibid 48-70.

different but related factors from the literature. The factors can be grouped into three categories – actor, structure, and (implementation) context – with two conditions each.[40] The actor category consists, first, of actors' attitudes and other related factors, which are important within the literature because they fundamentally contribute to the very decision whether and how EU law and legal decisions are implemented domestically.[41] Favourable preferences of political actors (governments and third parties), low domestic political conflict, and favourable political priorities of governments can be conceptualised as the main sub-categories ('attributes') of the condition *favourable attitudes*. Second, traditions play a considerable albeit diffuse role for the handling of EU law.[42] The most obvious aspects of the condition *favourable traditions* are administrative, legal, and political traditions. In this context, the legitimacy of institutions, procedures, and actors involved in implementation processes can be considered part of favourable political traditions.

The third condition, *compatible institutions*, belongs to the structure category and contains institutional aspects of implementation.[43] Structural features of the Member States and their influence on implementation constitute the first meso-level attribute of this condition (compatible state structure). The second attribute addresses the specific regulatory structure of a policy area affected in the implementing country (compatible regulatory structure). A fourth condition relates to different capacities needed to implement environmental law, conceptualised as *compatible capacities*.[44] Beside financial and human resources of administrative institutions, this also includes resources of societal actors and interest groups including their ability to mobilise (extensive resources). Moreover, a compatible regulatory style within the policy sector in question is part of this condition, referring to predominantly administrative patterns of acting on implementation issues and ways of interacting with societal or other third-party actors, including their involvement in the process.[45]

The fifth condition, *compatible policies*, is part of the context category and contains attributes that relate to the legal act in hand. One is the influence of specific characteristics of a policy that requires adaptation on the transposition process (compatible legal act features). Another attribute is the compatible domestic context of existing policies and practices affected by European legislation.[46] Finally, the sixth condition is part of the explanatory pattern *extensive enforcement*. It occupies a peculiar position compared to the other conditions, because not only does it constitute a potential explanation for implementation, but also one of the main phases of the implementation process,[47] albeit an optional one.

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[40] ibid 47.

[41] Ellen Mastenbroek and Michael Kaeding, 'Europeanization beyond the goodness of fit: Domestic politics in the forefront' (2006) 4(4) Comparative European Politics 331.

[42] Falkner et al (n 28); Gerda Falkner and Oliver Treib, 'Three Worlds of Compliance or Four? The EU-15 Compared to New Member States' (2008) 46(2) Journal of Common Market Studies 293.

[43] Giuseppe Ciavarini Azzi, 'The slow march of European legislation: The implementation of directives' in Karlheinz Neunreither and Antje Wiener (eds), *European Integration After Amsterdam: Institutional Dynamics and Prospects for Democracy* (Oxford University Press 2000).

[44] Ulf Sverdrup, 'Compliance and Conflict Management in the European Union: Nordic Exceptionalism' (2004) 27(1) Scandinavian Political Studies 23.

[45] Thomas König and Brooke Luetgert, 'Troubles with Transposition? Explaining Trends in Member-State Notification and the Delayed Transposition of EU Directives' (2009) 39(1) British Journal of Political Science 163.

[46] Tanja A Börzel and Thomas Risse, 'Conceptualizing the Domestic Impact of Europe' in Kevin Featherstone and Claudio M Radaelli (eds), *The Politics of Europeanization* (Oxford University Press 2003).

[47] Corcaci, 'Conceptual considerations' (n 6) 494-96.

Enforcement can be conceptualised as extensive infringement pressure and, in the EU context, aims at the Commission's possibilities to make Member States comply with EU law.[48] This refers to monitoring, (financial or knowledge-based) assistance from European institutions, the informal EU Pilot mechanism for informal dialogue between the Commission and the Member States, and the formal infringement procedure. The latter can be divided into a pre-litigation phase with a letter of formal notice and a reasoned opinion, and a litigation phase with referrals to the CJEU and a subsequent judgment including a lump-sum and/or a daily penalty payment (and in case of further non-compliance, a second letter of formal notice and proceedings before the CJEU). In contrast, the attribute 'extensive domestic enforcement' alludes to ensuring administrative implementation and practical application of transposed EU law by national enforcement institutions.[49]

Crucially, these conditions can be mapped onto two traditional theoretical perspectives that have been referenced frequently in the political science literature on implementation and compliance and provide an additional layer of theoretical foundation: the *management* and *enforcement approaches*.[50] They emanated from rationalist arguments in political economy[51] to highlight national capacities given willingness to comply (management), or the need to enforce compliance against national unwillingness (enforcement). Based on these theoretical perspectives and previous insights, the article conceptualises three conditions and apply them to environmental conflict resolution through two distinct *explanatory paths*, mirroring the two approaches. Both paths include either *positive* or *negative actor preferences* towards the policy and case at hand. Preferences have been widely shown to play an important role in processes of implementation[52] and are theoretically expected to occur in conjunction with other conditions to explain effective implementation, which is the focus in this article.

3 CONDITIONS FOR EFFECTIVE IMPLEMENTATION

3.1 LEGITIMACY OF CONFLICT RESOLUTION

First, the *perceived legitimacy*[53] of supra- and international institutions and procedures of conflict resolution (ICTs, implementation and compliance committees of MEAs), including resulting acts of contestation, has been proposed as an essential condition for national

[48] Mariasverd Mendrinou, 'Non-Compliance and the European Commission's Role in Integration' (1996) 3(1) Journal of European Public Policy 1.
[49] Karen J Alter, 'The European Union's Legal System and Domestic Policy: Spillover or Backlash?' (2000) 54(3) International Organization 489.
[50] Tallberg (n 7).
[51] Abram Chayes and Antonia Handler Chayes, 'On compliance' (1993) 47(2) International Organization 175.
[52] Peter Bursens and Kristof Geeraerts, 'EU Environmental Policy-Making in Belgium: Who Keeps the Gate?' (2006) 28(2) Journal of European Integration 159; Mastenbroek and Kaeding (n 41); Dimiter Toshkov, 'Embracing European Law' (2008) 9(3) European Union Politics 379; Treib (n 9); Corcaci *Compliance in der EU* (n 4).
[53] While legitimacy is commonly conceptualised as *normative* legitimacy in legal scholarship, i.e., based on predefined legal criteria (see Føllesdal (n 18) 480), this article follows a political science perspective that views legitimacy in the eyes of the beholder, i.e., based on actors' beliefs and perceptions (called *descriptive* legitimacy by Føllesdal, see below for more details).

implementation.[54] In case of high perceived legitimacy and without excluding alternative explanations, it is expected based on the *management approach* that implementation occurs when the relevant actors (especially the government and competent administrators, but also other influential political actors) have positive preferences about the decision at hand. Extending the argument by Tallberg and Zürn[55] on international organizations, legitimacy can influence the ability of resolution mechanisms to facilitate effective implementation and compliance, and it is thought of as a less costly path to achieving this goal than coercive measures. Indeed, '[e]vidence from a broad range of regulatory domains and levels suggests that legitimacy contributes to compliance, even when adjustment costs are high',[56] while its lack can negatively influence the acceptance of international rules and the underlying institutions.

ICTs can be thought of as a set of institutions (among others) which through their function as arbitrators have contributed to the interruption of the 'state of nature' at the international level.[57] Through their authority,[58] ICTs exert influence on war and peace, human rights, investment and trade, harmonisation of law, but they also can 'usurp law-making power or perpetuate global injustice and domination'.[59] However, exercising authority comes with certain requirements, especially the consent of nation states, acceptance of judgments and other decisions, as well as preventing states to exit ICTs' jurisdiction. Legitimacy is distinct from but related to authority as 'a relational property, determined by the beliefs and perceptions of audiences about the exercise of authority'.[60] Crucially, legitimacy implies accepting the authority of institutions such as European and international courts, even if individual decisions conflict with the 'narrow self-interest' of affected parties.[61] This approach can be combined with the three types (or: dimensions) of democratic legitimacy according to Schmidt:[62] *input, throughput, and output legitimacy*.[63] While not identical, a connection can be made with the three clusters of criticisms of legitimacy that Føllesdal describes[64] based on the concept of legitimate authority:[65] the origin of ICTs as institutions

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[54] Daniel Bodansky, 'The legitimacy of international governance: A coming challenge for international environmental law?' (1999) 93(3) American Journal of International Law 596; Føllesdal (n 18); Jonas Tallberg and Michael Zürn, 'The legitimacy and legitimation of international organizations: introduction and framework' (2019) 14(4) The Review of International Organizations 581; Christina Voigt (ed), *International Judicial Practice on the Environment. Questions of Legitimacy* (Cambridge University Press 2019).

[55] Tallberg and Zürn (n 54) 582.

[56] ibid.

[57] Føllesdal (n 18) 476.

[58] One possible understanding of authority 'refers to the recognition that an institution has the right to make decisions and interpretations within a particular area'. Tallberg and Zürn (n 54) 586.

[59] ibid.

[60] ibid.

[61] ibid 587.

[62] Vivien A Schmidt, *Europe's Crisis of Legitimacy: Governing by Rules and Ruling by Numbers in the Eurozone* (Oxford University Press 2020); building on Fritz W Scharpf, 'Economic integration, democracy and the welfare state' (1997) 4(1) Journal of European Public Policy 18; Fritz W Scharpf, *Governing in Europe: effective and democratic?* (Oxford University Press 1999).

[63] See also Tallberg and Zürn (n 54) 593-95 for a similar account.

[64] Føllesdal (n 18) 481-90.

[65] Joseph Raz, *The Morality of Freedom* (Clarendon Press 1986); see Richard Collins, 'Consent, Obligation and the Legitimate Authority of International Law' in Patrick Capps and Henrik P Olsen (eds), *Legal Authority beyond the State* (Cambridge University Press 2018); Tallberg and Zürn (n 54) 593-94. More concretely, Føllesdal argues that the various criticisms of ICTs' legitimacy can be reconstructed as putting their legitimate authority into question. Føllesdal (n 18) 477.

and state consent (indirectly linked to input legitimacy),[66] the appropriateness of their procedures (throughput legitimacy), and concerns about their effects and decisions (output legitimacy). Specifically, this includes the institutions themselves, for example the origins of investment tribunals or recent challenges of the International Criminal Court (input); the underlying procedures, including process-related challenges of how the CJEU interprets European treaties (throughput); and criticism of specific judgments and other decisions, for example regarding WTO bodies, the ITLOS, or judgments by the ECtHR (output).[67]

Implementation and compliance are affected by perceived legitimacy or what Føllesdal calls *descriptive* legitimacy, i.e., 'social facts concerning actors' beliefs about the legitimate authority'[68] (i.e., *normative* legitimacy) of ICTs. This is because such beliefs may facilitate implementation by providing additional arguments for the implementing parties or 'diffuse support' for ICTs even if the affected parties disagree with their legal interpretations or decisions, thus exerting a *normative compliance pull*.[69] Because non-compliance can affect how others perceive the legitimacy of ICTs, newly established institutions may tread carefully in the beginning, engaging in the so-called 'economy of legitimacy'[70] to build a positive reputation and thus their descriptive legitimacy. Lastly, compliance and implementation can go beyond beliefs and influence the normative legitimacy of ICTs either positively, compelling other states to defer their judgments decisions, or negatively by eroding legitimate authority of ICTs when their decisions are not widely followed.[71]

Beside general considerations on input, throughput, and output legitimacy, obligations related to *legal principles* are of relevance for the implementation of decisions in international environmental law. This field has produced a considerable number of new arrangements, rules, and obligations placed on nation states, which in turn affects its legitimacy and that of related institutions and resolution mechanisms. In this context, the obligation to apply the principles of precaution and prevention can be considered essential, the latter of which can be found in many MEAs and courts like the ITLOS have also incorporated it.[72] It implies that states have duties to 'prevent, reduce, and control transboundary pollution and environmental harm resulting from activities within their jurisdiction or control', but also to 'cooperate in mitigating transboundary environmental risks and emergencies'.[73] Debates on the precautionary approach and principle have also re-emerged in recent years based on an

[66] In contrast to throughput and output legitimacy, the link between input legitimacy and state consent to ICTs is weak because input legitimacy commonly refers to (citizens') political participation and representation in institutions. Schmidt (n 62) 31-32. One could argue that states provide at least indirect representation of their citizens when they negotiate treaties underlying ICTs and consent to their jurisdictions, although this is problematic in the case of authoritarian governments. Føllesdal (n 18) 482.

[67] Føllesdal (n 18) 476-77.

[68] ibid 480.

[69] Thomas M Franck, *The Power of Legitimacy among Nations* (Oxford University Press 1990) 24.

[70] Clifford J Carruba, 'A model of the endogenous development of judicial institutions in federal and international systems' (2009) 71(1) Journal of Politics 55.

[71] Føllesdal (n 18) 481.

[72] Malgosia Fitzmaurice, 'Legitimacy of International Environmental Law. The Sovereign States Overwhelmed by Obligations: Responsibility to React to Problems Beyond National Jurisdiction?' (2017) 77 Zeitschrift für ausländisches öffentliches Recht und Völkerrecht 339, 342-44; see Leslie-Anne Duvic-Paoli, 'Principle of Prevention' in Ludwig Krämer and Emanuela Orlando (eds), *Principles of Environmental Law* (Elgar Encyclopedia of Environmental Law series Vol. VI, Edward Elgar 2018).

[73] Alan Boyle and Catherine Redgwell, *Birnie, Boyle & Redgwell's International Law and the Environment* (4th edn, Oxford University Press 2021) 152-53.

ongoing discussion about its relevance.[74] It roughly states that measures to prevent the degradation of environmental damages should not be postponed based on incomplete scientific certainty, thus promoting precaution.[75] This means that nation states should actively take measures to prevent negative consequences of their activities on the environment and human health, even if scientific evidence on the long-term risks of such activities is not yet well-established. Despite placing significant burdens and obligations on nation states, the principle has been adopted as part of various MEAs including the Stockholm Convention and the Cartagena Protocol, but also by the ITLOS.[76] The precautionary principle and approach have been controversially discussed[77] and criticism directed for example at strong interpretations that imply a burden of proof on states creating environmental risks and the regulation of related activities that could potentially cause harm.[78]

Despite having developed 'through a consensual rather than an authoritative process',[79] the obligations resulting from basic legal principles in international environmental law do not always conform to this consensual perspective. For example, Fitzmaurice argues[80] that the precautionary principle has been introduced through authoritative processes, in the case of MEAs by their decision-making bodies. While obligations placed on nation states without their consent might therefore not be considered a legitimate basis for international environmental law, such a perspective does not negate the legitimacy of conflict resolution mechanisms beyond the nation state in general. Instead, it highlights both the political and legal complexity of legitimacy in this field. These observations implicitly support the theorised link between high (perceived) legitimacy of resolution mechanisms and positive actor preferences towards decisions. It remains to be seen whether the expected link is upheld empirically, or instead low perceived legitimacy combine with negative preferences in case of unduly burdens.

3.2 STRENGTH OF RESOLUTION MECHANISMS

Second, the sanctioning measures available to resolution mechanisms, such as supra- and international courts and non-compliance mechanisms and procedures, have been discussed as an essential condition of effective national implementation.[81] Without excluding

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[74] Jonathan B Wiener, 'Precautionary principle' in Ludwig Krämer and Emanuela Orlando (eds), *Principles of Environmental Law* (Elgar Encyclopedia of Environmental Law series Vol. VI, Edward Elgar 2018) 174-85; see Cass R Sunstein, *Averting Catastrophe. Decision Theory for COVID-19, Climate Change, and Potential Disasters of All Kinds* (New York University Press 2021) 43-60.

[75] ibid 43.

[76] Fitzmaurice (n 72) 356-58.

[77] Sven Ove Hansson, 'How Extreme Is the Precautionary Principle?' (2020) 14(3) NanoEthics 245.

[78] Kristel De Smedt and Ellen Vos, 'The Application of the Precautionary Principle in the EU' in Harald A Mieg (ed), *The Responsibility of Science* (Springer 2022); see already Cass R Sunstein, *Laws of Fear. Beyond the Precautionary Principle* (Cambridge University Press 2005).

[79] Bodansky, *The legitimacy* (n 54) 604.

[80] Fitzmaurice (n 72) 366-68.

[81] Anna Gizari-Xanthopoulou and Dimitra Manou, 'Complying with and enforcing of environmental law: a critical appraisal of the mechanisms used at the international and the European level' (2014) 13(3) International Journal of Environment and Sustainable Development 239; Martin Hedemann-Robinson, *Enforcement of International Environmental Law. Challenges and Responses at the International Level* (Routledge 2019); Tullio Treves, Attila Tanzi, Cesare Pitea, Chiara Ragni, and Laura Pineschi (eds), *Non-Compliance Procedures and Mechanisms and*

alternatives, it is expected that based on the *enforcement approach* resolution mechanisms with strong sanctioning mechanisms facilitate national implementation in conjunction with negative actor preferences towards the case at hand. Yet, especially legal scholars increasingly focus on NCMs when investigating MEAs.[82] Such mechanisms are often set up within the framework of MEAs to facilitate cooperation of the parties involved in conflicts, which can be vital to enforcing the working-level implementation of decisions. International environmental regulation can be characterised by structural deficits regarding its implementation.[83] MEAs have reacted to this perceived deficit by developing 'a *sui generis* type of compliance mechanisms'[84] to address implementation problems against the background of treaty law without dedicated dispute settlement institutions. These mechanisms have been described as *managerial*[85] and are usually non-confrontational, relying on cooperation between the dispute parties for success because they do not involve strong sanctioning measures.[86]

They subsequently open the door for what is called here *cooperative differentiation* due to the flexibility of the underlying process and lack of external sanctions, which would minimise or even penalise any attempts to adapt legal requirements (here: obligations resulting from environmental treaties) to national circumstances. Beside the aspects of intergenerational impact and justice,[87] one of the crucial issues in the context of environmental conflicts is the difficulty of identifying the party who is affected by a specific act of non-implementation and to specify the damages caused and tie them to the non-implementing party.[88] In the absence of specialised supra- and international ECTs, countries affected by environmental damages may thus engage what can be called *confrontational differentiation* because the complexity of environmental law facilitates processes of fragmentation. Affected parties can subsequently make use of 'forum shopping'[89] by splitting up their claims in several parts and use different dispute settlement bodies for each part to maximise their chances of success in achieving their goals.

Both European and international environmental law may be especially suited to replace strict formal adjudication with more collaborative mechanisms to resolve disputes. The effectiveness of traditional enforcement and adjudicative dispute resolution has indeed been

the Effectiveness of International Environmental Agreements (T.M.C. Asser Press 2009); Christina Voigt and Caroline Foster (eds), *International Courts versus Non-Compliance Mechanisms. Comparative Advantages in Strengthening Treaty Implementation* (*forthcoming*, Cambridge University Press 2024).

[82] Cardesa-Salzmann (n 36); Joyeeta Gupta, Courtney Vegelin, and Nicky Pouw, 'Lessons learnt from international environmental agreements for the Stockholm + 50 Conference: celebrating 20 Years of INEA' (2022) 22(2) International Environmental Agreements: Politics, Law and Economics 229; Gerhard Loibl, 'Compliance procedures and mechanisms' in Malgosia Fitzmaurice, Marcel Brus, and Panos Merkouris (eds), *Research Handbook on International Environmental Law* (2nd edn, Edward Elgar 2021).

[83] Cardesa-Salzmann (n 36) 586.

[84] ibid 587.

[85] ibid.

[86] Hedemann-Robinson (n 81) 44.

[87] Brunilda Pali, Miranda Forsyth, and Felicity Tepper (eds), *The Palgrave Handbook of Environmental Restorative Justice* (Palgrave Macmillan 2022).

[88] Cardesa-Salzmann (n 36) 587.

[89] ibid 588.

questioned in the relevant literature for some time.[90] Chayes and Handler Chayes argue[91] that adjudication does not account for the complexity and dynamic nature of environmental issues and instead call for a cooperative approach to solving disputes. In contrast to traditional economic approaches, management emphasises consultation and deliberation between the conflict parties based on a commitment to maintaining the underlying legal agreement, instead of referring to strict enforcement of certain obligations perceived to be broken by the other party.[92] Such approaches also criticise the slow process of traditional adjudication because of imminent danger of environmental damages that cannot be undone through such sanctioning mechanisms. Managerialist debates in academia and practice have actively influenced the practical establishment of various soft non-compliance mechanisms in MEAs, including Montreal Protocol on Ozone Depleting Substances.[93] Many environmental treaties have adapted similar NCMs since, for example United Nations treaties like the Basel and Rotterdam Conventions which, together with the Stockholm Convention on Persistent Organic Pollutants, are administered under the United Nations Environment Programme (UNEP). Conversely, the Conference of the Parties to the Stockholm Convention has decided to introduce compliance procedures only at their eleventh meeting in May 2023[94] after failing to do so in prior meetings due to a lack of consensus.[95]

Several characteristics separate such non-adversarial mechanisms from those with strong sanctioning measures. Conceptually, aspects such as the focus on cooperation can be understood as governance instruments, considering a managerial perspective that emphasises coordination above legal interactions. For example, the provision of assistance has been conceptualised as an administrative coordination (or governance) instrument in the context of multilevel interactions between national and international administrators.[96] The wide range of NCMs in environmental treaties with different structures and procedures are usually part of the treaty's framework and set up as subsidiary bodies with the aim of avoiding formal legal disputes through adjudication.[97] In this sense, they share characteristics with the EU Pilot mechanism aimed at solving implementation issues to avoid formal infringement procedures. Another feature of NCMs is their flexibility and broad scope that reaches beyond

[90] Abram Chayes and Antonia Handler Chayes, *The New Sovereignty. Compliance with International Regulatory Agreements* (Harvard University Press 1995); Geir Ulfstein, Thilo Marauhn, and Andreas Zimmermann (eds), *Making Treaties Work. Human Rights, Environment and Arms Control* (Cambridge University Press 2007); Voigt and Foster (n 81).
[91] Chayes and Handler Chayes, *The New Sovereignty* (n 90).
[92] Daniel Bodansky, *The Art and Craft of International Environmental Law* (Harvard University Press 2010) 236.
[93] Birgit Hollaus, 'The EU in multilateral environmental compliance mechanisms: an outside view' (2021) 5(1) Europe and the World: A law review 3.
[94] UNEP/POPS/COP.11/31, decision SC-11/19 <https://pops.int/Portals/0/download.aspx?d=UNEP-POPS-COP.11-31.English.pdf> accessed 10 December 2023.
[95] See Attila Tanzi and Cesare Pitea, 'Non-Compliance Mechanisms: Lessons Learned and the Way Forward' in Tullio Treves, Attila Tanzi, Cesare Pitea, Chiara Ragni, and Laura Pineschi (eds), *Non-Compliance Procedures and Mechanisms and the Effectiveness of International Environmental Agreements* (T.M.C. Asser Press 2009).
[96] Arthur Benz, Andreas Corcaci, and Jan W Doser, 'Unravelling multilevel administration. Patterns and dynamics of administrative co-ordination in European governance' (2016) 23(7) Journal of European Public Policy 999; Arthur Benz, Andreas Corcaci, and Jan W Doser, 'Multilevel Administration in International and National Contexts' in Michael W Bauer, Christoph Knill, and Steffen Eckhard (eds), *International bureaucracy: Challenges and lessons for public administration research* (Palgrave Macmillan 2017); Corcaci, 'The dynamics' (n 16).
[97] Hollaus (n 93) 4-5.

the confines of legal adjudication and legal language.[98] This benefits dynamic policy fields such as environmental policy because international courts and tribunals might not be effective in dealing with the subtle, often politically sensitive compromises that are required when dealing with environmental damage.[99] Exactly such compromises give conceptual rise to the ability of nation states to differentiate their implementation, as opposed to formal court rulings which generally leave less room for adaptation. This argument is further strengthened by the lower strictness of these mechanisms, which aim for 'acceptable levels'[100] of implementation and are limited to 'facilitative measures'[101] (again except for the Kyoto-related mechanisms that include stronger enforcement measures), thus allowing for compromises in adaptation.

Reflecting their collaborative nature and flexibility, the institutional setup of NCMs and their committees vary widely, for example in terms of their composition, size, and decision-making rules. They are usually set up in a way that represents the diversity of MEA's Member States and their interests, which is particularly useful in environmental matters often affecting small or so-called 'least developed' countries but also Indigenous communities.[102] Furthermore, many NCMs only have a managerial mandate and consist of experts from different disciplines, whereas courts and tribunals are generally dominated by legal experts. Some NCMs like those related to the Kyoto Protocol, the Aarhus Convention, and the Protocol on Water and Health have, however, been termed 'quasi-judicial' because of their broader and more independent mandate where the compliance body can recommend or even directly adopt sanction-like measures.[103] The question of who can initiate non-compliance procedures depends on the treaty and includes Member States of the MEA, its secretariat, and NGOs. In contrast to international courts, the non-implementing country itself is the most common initiator, again stressing the non-adversarial character of NCMs.[104] Finally, initial insights from the literature imply mixed results regarding their performance of and dependence on the specific implementation regime. The activities of 'softer' NCMs cover various forms of (technical or financial) assistance, although in the case of the Basel Convention general implementation assessments have given way to reporting requirements. MEAs with enforcement capabilities have subsequently led to more formal sanctions, such as the suspension of rights and privileges (Kyoto Protocol) and even trade restrictions (Montreal Protocol).[105] However, general assessments of the effectiveness of compliance mechanisms are difficult and knowledge about their precise impact on improving implementation remains diffuse, thus requiring further empirical investigation. Political considerations also play an important role for developing compliance mechanisms, while the diversity of MEAs prevents the establishment of a 'uniform approach' to NCMs.[106]

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[98] However, this argument has been criticised, for example by Martti Koskenniemi, 'The Fate of Public International Law: Between Technique and Politics' (2007) 70(1) The Modern Law Review 1.
[99] Cardesa-Salzmann (n 36) 592.
[100] ibid 595.
[101] ibid 596.
[102] Cardesa-Salzmann (n 36) 593.
[103] Alessandro Fodella, 'Structural and Institutional Aspects of Non-Compliance Mechanisms' in Tullio Treves, Attila Tanzi, Cesare Pitea, Chiara Ragni, and Laura Pineschi (eds), *Non-Compliance Procedures and Mechanisms and the Effectiveness of International Environmental Agreements* (T.M.C. Asser Press 2009) 361-62.
[104] Cardesa-Salzmann (n 36) 594-95.
[105] ibid 597-600.
[106] Hedemann-Robinson (n 81) 42.

3.3 CONNECTIONS TO MANAGEMENT AND ENFORCEMENT

From these observations, a connection can be made between resolution mechanisms that are perceived as legitimate and positive preferences towards a decision, especially of the competent actors from non-implementing countries. The absence of a perceived threat of strong sanctions implicitly relates this conjunction of conditions to MEAs with soft implementation and compliance mechanisms that are based on cooperative approaches to the resolution of conflicts. Therefore, MEAs with such mechanisms are one (of several possible) empirical expression of this *explanatory path* for effective national implementation. Conversely and without excluding alternative explanations, such as the combination of different legal mechanisms in the sense of 'forum shopping',[107] a second connection can be made between resolution mechanisms with strong sanctioning measures, especially European and international courts, and negative preferences towards a decision. This is due to the underlying pressure of sanctions and expected negative consequences of being sanctioned in case of non-implementation. Perceptions of legitimacy may vary in these cases, although the total rejection of an international legal institution can act as a prohibitive scope condition in this context. Therefore, European and international courts with strong sanctioning capabilities are one of several possible empirical expressions of the second explanatory path theorised in this article. Based on this discussion, it is thus hypothesised:

> **H_1:** *Resolution mechanisms perceived as highly legitimate given positive actor preferences towards the resolution [and the presence of managerial mechanisms] lead to effective implementation.*
>
> **H_2:** *Resolution mechanisms with strong sanctioning measures given negative actor preferences towards the resolution [and varying legitimacy] lead to effective implementation.*

These hypotheses connect the national implementation of decisions to mechanisms of environmental conflict resolution in European and international decision-making bodies. The first explanation (H_1) can be connected to the *management* approach because it points towards the ability and capacities of the implementing party and implies that positive actor preferences in conjunction with high perceived legitimacy of the resolution mechanism leads to the effective national implementation of decisions in the absence of specialised ECTs beyond the nation state. The second explanation (H_2) is related to the *enforcement* approach because it focuses on sanctioning strategies to facilitate implementation.[108] It is thus expected that strong sanctioning mechanisms lead to effective implementation given negative actor preferences towards the decision, which are compensated by enforcement measures.

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[107] Aynsley Kellow, 'Multi-level and multi-arena governance: the limits of integration and the possibilities of forum shopping' (2012) 12(4) International Environmental Agreements: Politics, Law and Economics 327.
[108] Tallberg (n 7) 609.

4 CONCEPT STRUCTURAL FOUNDATIONS

4.1 CONCEPT STRUCTURAL METHODOLOGY

To connect conceptual insights and empirical analysis, a novel research design is developed based on the idea of *concept structures*,[109] a formalised methodology of concept construction in the social sciences. It can be expressed formally with the help of set theory and uses formal logic to specify concepts and conceptual and empirical relationships at the core of social research. This approach is uniquely suited for studies that combine strong theory building and empirical analysis because it inherently integrates theory and empirics and thus strengthens their coherence more than many other research designs. It does so by formally connecting concepts with explanatory conditions and outcomes used in subsequent empirical analysis. The concept structure developed in this article constitutes a *theory-driven formalised framework* that, first, provides the basic analytical categories required for data gathering and empirical assessment. It is especially viable to conduct set theoretic multimethod research (SMMR) based on *Qualitative Comparative Analysis* (QCA)[110] and subsequent process tracing. Thus, QCA (a configurational approach to causality) is combined with process tracing (a mechanistic view) to study both 'why' and 'how' of the phenomenon under investigation.[111] The addition of concept structures to theory-driven empirical research is based on earlier work[112] and lends itself to QCA, a method rooted in philosophy (formal logic) and mathematics (set theory, Boolean algebra), because it is constructed from the same formal logical and set theoretic principles. QCA is intrinsically designed to move back and forth between theory and evidence[113] to explain medium-*n* case[114] numbers through combinations of sufficient conditions ('configurations'). From the hypotheses and a theoretical understanding of *what it means* to implement decisions, a concept structure is built that illustrates both the theoretically expected explanatory paths and the concept of implementation.

Concepts play a vital role in the social sciences both as parts of theories and to provide systematic meaning to the categories used in social research. However, approaches to formalise concepts with the aim of connecting them to measurement and empirical analysis are sparse. To this end, this article employs a mid-range approach to concept structural research designs based on the *concept construction and use* framework by Goertz,[115] which clarifies how multilevel concepts can be formalised from a set-theoretical perspective. The mid-range approach implies building a concept structure based on theoretical and empirical

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[109] Goertz, *Social Science Concepts* (n 4); Goertz, *Social Science Concepts and Measurement* (n 4); see also Corcaci, *Compliance in der EU* (n 4).

[110] See Charles C Ragin, *The Comparative Method: Moving Beyond Qualitative and Quantitative Strategies* (University of California Press 1987); Patrick A Mello, *Qualitative Comparative Analysis: An Introduction to Research Design and Application* (Georgetown University Press 2021); for international law, see Pablo Castillo-Ortiz, 'Chapter 19: Qualitative Comparative Analysis (QCA) as an empirical method for international law' in Rossana Deplano and Nikolaos K Tsagourias (eds), *Research Methods in International Law* (Edward Elgar 2021).

[111] Valérie Pattyn, Priscilla Álamos-Concha, Bart Cambré, Benoît Rihoux, and Benjamin Schalembier, 'Policy Effectiveness through Configurational and Mechanistic Lenses: Lessons for Concept Development' (2022) 24(1) Journal of Comparative Policy Analysis 33.

[112] Corcaci, *Compliance in der EU* (n 4) 100-08.

[113] Charles C Ragin, *Fuzzy-set social science* (The University of Chicago Press 2000) 45.

[114] In this section, 'case' refers to the observational unit used in social research, not to legal cases.

[115] Goertz, *Social Science Concepts* (n 4); Goertz, *Social Science Concepts and Measurement* (n 4).

knowledge as the 'ontological' or analytical dimension of the research design, and subsequently conducting empirical analysis through configurative methods as its explanatory component.[116] While Goertz stresses[117] that conceptual frameworks sometimes 'end with a quantitative measure that can be used in causal-statistical analysis', his semantic and ontological framework of concepts is based on a different conception of causality than correlational and factor-analytic statistics. It also assumes a different relationship between explanans and explanandum of a phenomenon, which the author describes as 'structural principles for constructing multidimensional and multilevel concepts'.[118]

The first principle goes back to Aristotle and rests on necessary and sufficient conditions to define concepts. It can be interpreted as representing well-defined or *classical categories*,[119] because it provides fully defined and complete descriptions of the underlying concepts. A conjunctive occurrence of several attributes is necessary and sufficient to describe a given concept, for example: A*B*C = Y. The second principle is connected to Wittgenstein's idea of family resemblance. It can be linked to so-called *radial categories*[120] where some attributes may be sufficient to account for the presence of a concept, but other possibilities should also be considered, for example: A*B+B*C+A*C → Y. This approach represents *equifinality* because it allows for different but equally valid ways an outcome (here: a concept) can be described or explained without excluding other descriptions in separate contexts and without stipulating a single complete description. Both construction principles are at least implicitly based on the mathematical foundations of formal logic and set theory, Boolean algebra. This is why they can be formalised accordingly when expanded to in-between concept relationships, for example through set-theoretic methods such as QCA, which is used to analyse sufficiency relationships.

In reference to Aristotelian logic, Goertz argues that the logical operator AND represents the logic of necessary and sufficient conditions because it links several necessary conditions, which in conjunction become sufficient to account for a specific outcome. More precisely, AND links several so-called INUS conditions (insufficient but necessary parts of a condition that is unnecessary but sufficient for the outcome),[121] which constitute a sufficient explanation. What is usually referred to as 'a cause' in colloquial speech can often be described more precisely as an INUS condition, because many causes are in fact parts of a conjunction of several necessary attributes, which together form one sufficient cause for an outcome. Going beyond this understanding, a sufficient condition consisting of several INUS conditions only represents *one among several* possible explanations for an outcome. This alludes to equifinality, which is where the logical operator OR comes into play. It links equifinal (i.e., separate but equally valid) sufficient conditions that each lead to the outcome in question. Goertz, in contrast, connects OR to the family resemblance structure, because the presence of any *m* out of *n* conditions is sufficient to explain an outcome.[122] This,

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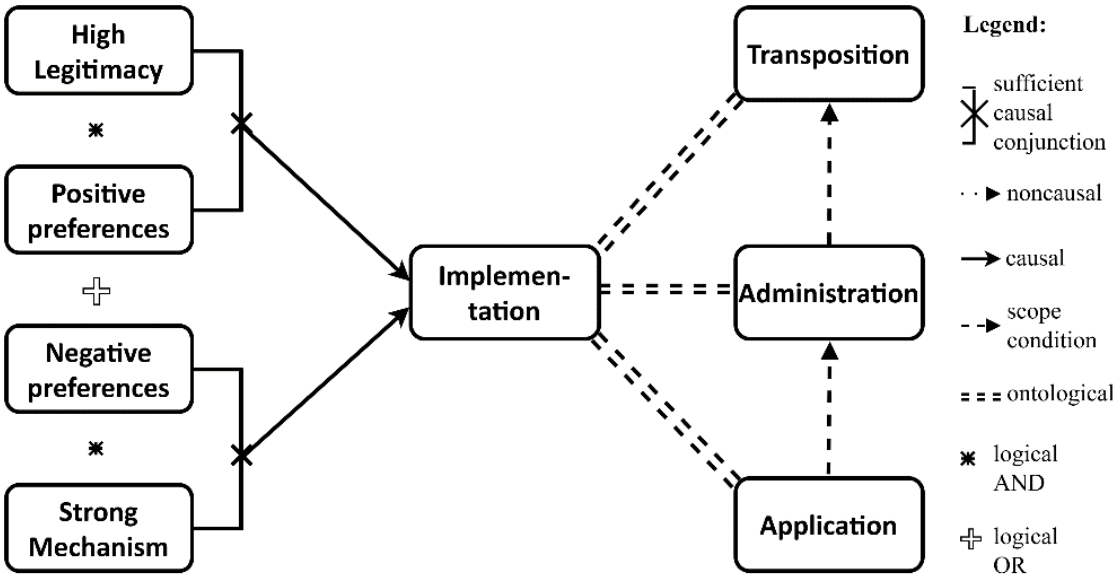
[116] Corcaci, *Compliance in der EU* (n 4) 104-05.
[117] Goertz, *Social Science Concepts and Measurement* (n 4) 31.
[118] Goertz, *Social Science Concepts* (n 4) 7.
[119] David Collier and James E. Mahon, 'Conceptual "Stretching" Revisited: Adapting Categories in Comparative Analysis' (1993) 87(4) American Political Science Review 845, 846.
[120] Collier and Mahon (n 119) 848.
[121] See James Mahoney, Erin Kimball, and Kendra L. Koivu, 'The Logic of Historical Explanation in the Social Sciences' (2009) 42(1) Comparative Political Studies 114, 126.
[122] Goertz, *Social Science Concepts* (n 4) 45.

however, does not exactly correspond to the notion of equifinality and the function of this operator in Boolean algebra and formal logic.

4.2 A CONCEPT STRUCTURE OF THE IMPLEMENTATION OF DECISIONS ON ENVIRONMENTAL CONFLICTS

With this methodological background in mind, the implementation concept structure is shown in *Figure 1*.

Figure 1: Implementation concept structure



Source: author's illustration

The left side of the illustration represents the two expected explanations for the outcome *effective implementation of court judgments and managerial decisions* (IMP) and their logical connections as per hypotheses H_1 and H_2. While the first explanatory path consists of the conditions *high perceived legitimacy* (HPL) AND *positive actor preferences* (PAP), the second includes *negative actor preferences* (NAP) AND *strong resolution mechanism* (SRM). The logical *AND* (in formal notation: '*') implies a 'causal' (i.e., explanatory) conjunction (more specifically, it identifies INUS conditions). Taken together, the two paths form a *sufficient explanation* for the outcome (so-called 'conjunctural causation'). The paths are connected through a logical *OR* ('+'), implying equifinality, i.e., different configurations of conditions can lead to the same outcome. This means that each sufficient condition (or combinations thereof, connected through logical ANDs) constitutes one of several separate but equally valid explanations for implementation ('equifinal causation'). In formal notation, they can be expressed as:

$$\mathbf{H_{1+2}}: HPL*PAP + SRM*NAP \rightarrow IMP$$

High legitimacy and positive preferences may be accompanied by 'soft' managerial mechanisms, set theoretically expressed as the *absence* of a strong mechanism, formally: *HPL*PAP*~SRM* (read: 'not SRM'). Other explanations, such as a conjunction of a strong

mechanism and positive preferences or other conditions altogether could occur empirically. Two strategies to deal with alternative explanations are proposed here: First, the feature of QCA to move back and forth between theory and data by re-examining affected cases in more detail can be used to update the concept structure (for example by adding a condition). Second, so-called 'deviant cases'[123] can be analysed through process tracing. To check model robustness, simulations can be run in which solutions are compared under different analytical settings. These concern the 'calibration' (i.e., operationalization) of the conditions and outcomes, and strategies of handling 'logical remainders', logically possible combinations of conditions that are not covered by empirical data.

The right side of the illustration clarifies the *ontological* part of the conceptual framework, i.e., what implementation *is*. In previous work on policy implementation in the EU,[124] three conceptual parts are identified of what it means to implement law effectively: *transposition* of a legal act into national law (TRA); establishment of *administrative* structures and processes to implement a legal act (ADM); and its practical *application* (APP). This article extends this characterisation of implementation processes to court judgments and other decisions by supra- and international bodies as their implementation at least *potentially* also consist of these conceptual parts. Indeed, as has been shown,[125] court judgments by the CJEU follow analogous processes of transposition, administrative implementation, and practical application. In ideal theory, the relationship between these three components is one of *non-causal necessity*, i.e., transposing a court decision into national law is a necessary (non-causal) condition to implement required structural and procedural changes, which in turn is a necessary (non-causal) condition to apply the decision in full. Empirically, a focus can be put on explaining the overarching outcome 'implementation', thus considering its components as part of the outcome specification and data collection.

Whether confrontational, formal sanctioning mechanisms or cooperative, informal NCMs facilitate the implementation of court judgments and managerial decisions beyond the nation state is a topic of growing interest in the literature,[126] including the question of whether NCMs are always 'soft'.[127] Making use of concept structures with set-theoretical categories as outlined above can be helpful to theorise and empirically compare the distinct types of enforcement along an axis ranging from soft/weak to hard/strong. Using set-theoretic methods, a particularly soft non-compliance mechanism can be considered 'mostly out of the set' (of strong enforcement mechanisms), while a particularly strong sanction mechanism, such as the ability of the CJEU to impose significant daily fines, would be considered 'mostly in the set'. In between these extremes, *fuzzy sets* allow for a difference-in-

[123] Harry Eckstein, 'Case studies and theory in political science' in Fred Greenstein and Nelson Polsby (eds), *Strategies of Inquiry. Handbook of Political Science* (Vol. 7, Addison-Wesley 1975); Jack S Levy, 'Case Studies: Types, Designs, and Logics of Inference' (2008) 25(1) Conflict Management and Peace Science 1.
[124] Corcaci, *Compliance in der EU* (n 4) ch. 3.2.
[125] ibid 73-74.
[126] Cardesa-Salzmann (n 36); Malgosia Fitzmaurice and Catherine Redgwell, 'Environmental non-compliance procedures and international law' (2000) 31 Netherlands Yearbook of International Law 35; John G Merrills, *International Dispute Settlement* (Cambridge University Press 2017); Treves et al (n 81).
[127] Elena Fasoli and Alistair McGlone, 'The Non-Compliance Mechanism Under the Aarhus Convention as "Soft" Enforcement of International Environmental Law: Not So Soft After All!' (2018) 65(1) Netherlands International Law Review 27.

degree[128] with gradual set memberships and thus for the categorisation of a range from formal to informal non-compliance mechanisms. This way of calibrating conditions and outcomes can help make sense of and enable comparisons between enforcement types across different resolution mechanisms.

5 EMPIRICAL IMPLICATIONS

As a framework for analysis, the implementation concept structure can be applied empirically in a variety of ways, one of which is outlined briefly here to illustrate its potential. Concept structures lend themselves to *configurational* research methods due to their connections to formal logic. Therefore, a set theoretic multimethod approach could be followed: data gathering based on public documents and complementary expert interviews (first step), a broader comparative examination via QCA (second step), and in-depth process tracing of selected deviant or unexpected cases from the QCA (third step).

In terms of case[129] selection, cases can be defined as national implementation processes of supra- and international court judgments and managerial decisions on environmental conflicts. In line with the aim to gain generalisable insights through comparison, specific implementation processes can be selected to cover important decisions from both resolution mechanisms. They can be chosen to broadly match courts with NCMs in terms of environmental conflict area, while accounting for sufficient case numbers and variation. First, conflict resolution through courts can be considered, specifically the CJEU (judgments on hazardous waste and chemicals), the ICJ (judgments on sustainable water resource management), and the International Tribunal for the Law of the Sea (ITLOS; judgments on protection of the marine environment). Conflicts decided in courts are *legally binding* and usually feature strong sanctioning measures that can carry significant punitive measures (regardless of their enforceability), sometimes including financial penalties (for example in case of the CJEU). Consequently, ensuring implementation would not depend on perceptions of their legitimacy by the affected parties, which may vary in these cases. Second, decisions from non-compliance mechanisms in MEAs can be considered, specifically the Basel and Rotterdam Conventions on hazardous waste and chemicals (substantive match to CJEU), the Water Convention and the Protocol on Water and Health (matches ICJ), and NCMs in Regional Fishery Management Organisations (matches ITLOS). Such MEAs usually do not feature legally binding procedures to enforce decisions but non-confrontational, managerial mechanisms. Thus, they may need to rely on, or at least can benefit from, referring to their legitimacy to ensure implementation. Including four implementation processes per court and matching NCM would create a baseline of twenty-four cases, well-suited for a formal analysis using QCA with three conditions.

First, qualitative data on the explanatory conditions and outcome can be gathered from public documents, such as monitoring reports and official statements on implementation, but also existing research, such as case studies and legal opinions or commentaries. Complementary qualitative interviews with experts from academia and practice (for example academics, judges, administrators engaged in non-compliance procedures, national

[128] Carsten Q Schneider and Claudius Wagemann, *Set-Theoretic Methods for the Social Sciences. A Guide to Qualitative Comparative Analysis* (Cambridge University Press 2012) 27.
[129] In this section, 'case' refers to the observational unit used in social research, not to legal cases.

representatives involved with implementation) can be conducted to account for missing information and to contextualise the implementation process. If required, document and interview data can be structured via qualitative content analysis to prepare empirical analysis. Second, QCA can be used based on the implementation concept structure to verify the hypotheses and identify systematic trends not yet accounted for by prior research and conceptual considerations. The conditions and outcome can be calibrated using fuzzy sets to assure sufficient variation, qualitatively measured, and coded based on document and interview data (see *Table 2*). Results can be discussed in a comparative case study. Finally, deviant or unexpected cases from the QCA can be assessed in more detail if they either contradict the concept structure or are not covered by the results. Subsequently, in-depth process tracing[130] can be conducted to find additional conditions or within-case reasons for contradictions. This would provide new insights compared to the QCA alone and used to update the implementation framework and further develop the underlying theory.

Table 2: Measurement and operationalisation

Measurement	Condition/Outcome	Calibration
Qualitative measurement of conditions and outcome: based on data gathered from public documents and through interviews *Measurement based on quadrivalent fuzzy set:* 0 (fully out of the set) 0.33 (more out than in) 0.67 (more in than out) 1 (fully in the set)	*Actor preferences* (by actors responsible for implementing judgments or other decisions)	0: fully against implementation of case at hand (i.e., court judgment or managerial decision) 0.33: partly against implementation (open to change) 0.67: partly for implementation (with reservations) 1: fully for implementation
	Perceived legitimacy (by actors responsible for implementing judgments or other decisions)	0: resolution mechanism and procedure perceived as fully illegitimate 0.33: low perceived legitimacy 0.67: perceived as legitimate with restrictions 1: perceived as fully legitimate
	Strength of resolution mechanism (court judgment or managerial decision)	0: voluntary mechanism without consequences for the implementing party 0.33: voluntary mechanism with consequences 0.67: legally binding mechanism with weak consequences 1: legally binding mechanism with strong consequences/financial penalties
	Effectiveness of implementation (overall outcome, includes formal	0: (almost) no implementation of the court judgment/ managerial decision 0.33: partial implementation, major restrictions

[130] Pattyn et al (n 111).

	transposition, administrative structures/ procedures, application)	0.67: substantial implementation, minor restrictions 1: full implementation occurred

Source: author's illustration

To select suitable cases for the last step, two case types can be considered: 'deviant in consistency' and 'deviant in coverage'. *Deviant cases in consistency* suggest a contradiction in the solution terms (i.e., explanations) of the QCA, where a follow-up case study of the deviant case can be beneficial for detecting scope condition(s) of the solution that would differentiate the deviant case(s) from other typical case(s). *Deviant cases in coverage* do not contradict the solution but suggest unspecified solution terms. A case study can help to uncover alternative explanations that would cover such deviant case(s). Based on these case types, two comparative strategies to enhance causal inference can be considered:[131] First, deviant cases in consistency can be compared to typical cases to identify scope conditions and thus support causal inference of the solution term. Second, deviant cases in coverage can be compared to 'individually irrelevant cases', which lack empirical attributes to generate causal mechanisms of the QCA solution, i.e., X=0 and Y=0. Such comparisons can highlight alternative explanatory pathways.

The multimethod empirical application outlined here seems well-suited for various reasons: First, it helps assess the underlying hypotheses, especially whether strong sanctioning mechanisms or cooperative non-compliance mechanisms can account for implementation of decisions given negative actor preferences (without excluding the possibility of 'forum shopping'). Second, because of its comparative nature, QCA can unveil systematic trends that have not been accounted for by prior research. Third, the influence of other conditions, such as the role of different institutions, the legal apparatus (court-, tribunal-, treaty-type mechanisms), domestic socialisation, legal mobilization, and civil society can be inferred indirectly in case the results fail to explain most cases or if the quality of the results is low according to the method's quality parameters. This approach would enable a systematic analysis, which can unravel the complex explanatory relationships for medium (QCA) and small (process tracing) case numbers. Due to a close connection between conceptual and empirical levels, it could advance our understanding of the national implementation of supra- and international environmental conflicts, a crucial but so far sparsely analysed area of judicial governance and implementation research.

6 CONCLUDING REMARKS

In this article, a concept structural methodology was outlined to theorise environmental conflict resolution and the national implementation of related judgments from supra- and international courts and managerial decisions from non-compliance mechanisms. Following a political science perspective, legal contributions are referenced to contextualise the research, and an integrated trans-disciplinary terminology is proposed to account for different disciplinary viewpoints relevant to this article. Environmental conflict resolution

[131] Schneider and Rohlfing (n 5).

was conceptualised from the perspective of previous work on implementation in the EU and by connecting different strands of literature with a focus on political science, while also integrating legal research (section 2). Subsequently, two core conditions have been explored for effective implementation against the background of varying actor preferences. Derived from the management and enforcement approaches, the focus has been on the perceived legitimacy of institutions and processes of conflict resolution as well as the mechanisms used to resolve conflicts and the strength of their sanctioning measures (section 3). The article has then elaborated on the concept structural foundations of policy implementation and has outlined an implementation concept structure, which theorises key concepts and serves as a basis for empirical analysis (section 4). Finally, empirical implications of the resulting framework were discussed (section 5).

The article advances research on comparative implementation research by enabling empirical comparisons of implementation processes across distinct types of court-type and NCM-type resolution mechanisms. It also assesses the role that legitimacy and more cooperative non-compliance mechanisms can play in this context, thus bridging the gap between various resolution mechanisms and their relationship to national implementation. Future conceptual and empirical research can directly feed back into the concept structure for further theoretical development. Legal researchers can also benefit from this article through inspiration to integrate this innovative, concept structural framework into their research design as a step before carrying out a detailed systematic doctrinal legal analysis. Coming back to the example mentioned in the introduction, this framework could for instance be applied to the extensive CJEU case law regarding Directive 2008/50 on the protection of ambient air in the EU. Doing so would allow legal researchers to assess the effectiveness across resolution mechanisms accounting for both judgments and managerial decisions. The same theoretical framework could also be adapted for use in other fields of analysing resolution mechanisms in international and European law. It thus provides an explanatory component for identifying macro trends which may yield insights that complement and go beyond legal doctrinal analysis, such as evidence for the most effective legal designs in a specific field of law.

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